103

UNFAIR COMPETITION FROM THE PUBLIC SECTOR AND GOVERNMENT SUPPORTED ENTITIES: NON-PROFITS

Y 4.SM 1:103-88

Unfair Competition From the Public...

HEARING

BEFORE THE

SUBCOMMITTEE ON PROCUREMENT, TAXATION, AND TOURISM

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

WASHINGTON, DC, JUNE 16, 1994

Printed for the use of the Committee on Small Business

Serial No. 103-88

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UNFAIR COMPETITION FROM THE PUBLIC SECTOR AND GOVERNMENT SUPPORTED ENTITIES: NONPROFITS

THURSDAY, JUNE 16, 1994

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON PROCUREMENT,
TAXATION, AND TOURISM,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2359–A, Rayburn House Office Building, Hon. James H. Bilbray (chairman of the subcommittee) presiding.

Chairman BILBRAY. I would ask the panel to come in order first.

Mr. Santini, I understand is running a few minutes late. He had a little accident last night.

Mr. Alan Weinberger, Mr. David Applebaum, Mr. John McCarthy, Mr. F. Dewayne Foskey, and Mr. Richard Doherty.

First, we appreciate all of you coming today.

For some of you that are viewing this, this is the Subcommittee on Procurement, Taxation, and Tourism of the Small Business Committee. So, if you are here for Armed Services or Banking, you are in the wrong committee room.

Today the subcommittee continues its investigation of unfair competitive practices from Government entities and Government-supported institutions. As a matter of background, this investigation began last year as the subcommittee focused on the particular concerns of the travel and tourism industry.

The issues brought up by the small businesses that testified before us at that time made it clear that there was a much broader range of concerns in a number of other industries that deserved further exploration. This is the point of view which we are at today.

The subcommittee has sought to explore these expanded concerns by dividing our investigation into three hearings: Government unfair competition, nonprofits, and public utilities. So, we have the three areas.

I had hoped to begin with the discussion of the unfair activities that our own Government has been involved in. However, due to scheduling conflicts, that hearing has been shifted to June 28. Therefore, we will begin with the concerns regarding nonprofits.

The subcommittee enters this discussion with an open mind and no preconceived notions. The subcommittee acknowledges the great service and benefits that nonprofits provide our society.

It is our intention to allow both the private sector and the public sector an opportunity to express their understanding of the issues and try to clear the confusion and questions that surround the commercial activities of nonprofits.

Our goal is to clear up the abuses that may be taking place and to ensure the continued viability of and the confidence in nonprofits. However, we must also keep in mind that this issue has been deemed important enough to not only be included as an issue for the upcoming White House Conference on Small Business and has gotten a great deal of attention in addition from the Committee on Ways and Means.

As of 1993, there were 1,110,265 organizations exempt from taxation under Section 501. You know, that is almost 1 nonprofit for every 200 people in this country.

In 1993, 527,847 of these organizations filed information returns with the IRS. In that same year, 43,975 new organizations were approved. Leading to this period, IRS staffing with regards to the examination and determination of tax exemption has remained fairly consistent, around 500 employees to audit all 527,000 returns.

These 500 employees are responsible for not only new applicants but also managing investigations with regard to existing nonprofits.

This subcommittee concurs with the Oversight Subcommittee of the Committee on Ways and Means that there is a need for stronger oversight by the IRS over the activities of nonprofit organizations. The staffing and funding levels allocated to the IRS should be commensurate to the number, size, and diverse activities of tax-exempt organizations.

This improvement should also included a review and upgrading of reporting requirements, along with stricter reporting requirements from nonprofits.

However, we must also keep in mind a number of questions that have arisen with regard to the Unrelated Business Income Tax. The explosion of nonprofits as signified by the figures that were stated earlier, have no doubt strained the traditional donor bases of many nonprofits.

It is natural in this atmosphere for these organizations to seek new sources of income, particularly through commercial activities. While each activity is unique in its own way, the entry into commercial activities has placed nonprofits in direct competition with small businesses in a variety of industries.

In addition, the advantage that nonprofits hold due to their tax-exempt status has given them a clear financial advantage.

In a 1987 report to the Joint Committee on Taxation, the General Accounting Office reported not only how the disproportionate IRS staffing affected their investigation capacity but how it was compounded due to the difficulty of administering the UBIT, which is the unrelated business activities.

Congress' intent with the UBIT was to prevent unfair competition between taxable businesses and nonprofits with respect to the commercial activities unrelated to the exempt purpose. The IRS stated at that time that the criterion is difficult because there are

no concrete rules to determine the relationship between commercial activities and tax-exempt purpose.

In addition, a number of questions were raised about the large number of exemption categories. Because of this, the questions that were raised by this report and because most of them still remain, I have written to the Comptroller General and asked him to provide this subcommittee with an update of that report.

This is a concern brought to us by small businesses and affecting small businesses. If small businesses are to maintain their viability in the commercial environment, we must not throw any more roadblocks in their path or make the playing field uneven.

Whatever confusion may be resulting due to IRS inadequacies or problems within the UBIT rules should be rectified in order to allow a level playing field that will promote small business opportunities and foster nonprofit charitable purposes. To this end, we have asked two panels of witnesses to come before us today.

Representing the private sector, we will have: The Business Coalition for Fair Competition; the Textile Rental Services Association; the Computing Technology Industry Association; the Association of Quality Clubs; the National Child Care Association; and the National Association for Medical Equipment Services.

For the nonprofits, we will receive testimony from the United Cerebral Palsy Association representing the independent sector, YMCA, Gunston Hall, and the National Association of State Universities and Land Grant Colleges

We appreciate all of you coming today, and I see Mr. Santini has gotten over his fender-bender from last night and has managed to get here.

Jim is a former Congressman from Nevada. So, we welcome our colleague back and in fact, Jim and I were Deputy District Attorneys way back when about—10 years ago I guess it was Jim; right?

I would like you to start the testimony and we would just follow in order as you are kind of key to lead this off.

Mr. Santini.

[Chairman Bilbray's statement may be found in the appendix.]

TESTIMONY OF JIM SANTINI, BUSINESS COALITION FOR FAIR COMPETITION

Mr. SANTINI. Thank you, Mr. Chairman.

What is the growing phenomenon that has led to the recent findings, "many nonprofits operate just like for-profit businesses. They make huge profits, pay handsome salaries, build office towers, invest billions of dollars in stocks and bonds, employ lobbyists, and use political action committees to influence legislation. Increasingly, they compete with the tax-paying field." This is the Philadelphia Inquirer article of April 15, 1993.

Continuing a different quote. "The Department of Energy National Laboratories aggressive self-marketing threatens to step on a chunk of private sector stuff. With budgets tightening and future unclear, Energy Department laboratories are hawking their knowledge, facilities and services to the private industry and other Federal agencies." Washington Technology, March 24, 1994.

Another quote: "With revenues last year $1.8 billion, YMCA has become the Nation's leading health club operator. It is also the big-

gest provider of child care services. Thanks to its tax-exempt status, the Y can compete against for-profit operators with a 25 to 30 percent cost advantage." That is from Forbes Magazine, April 11th, this year.

We note this growing phenomenon to be a product of assertion being played out today in actual practice that the ends justify the means of generating for-profit dollars to support what is already a subsidized endeavor: A Government facility or service or organization with a public mission.

First, I commend you. You are showing by this examination of the issues surrounding unfair competition—from both Government and nonprofit organizations, through these hearings you are illustrating your commitment to small business.

Before we continue on this track, I would like to share a moment to tell you about us, Mr. Chairman.

By way of background, the BCFC is an alliance representing thousands of U.S. businesses in many areas of our economy. Our membership includes trade, professional associations, and individual businesses.

For more than a decade, the BCFC has articulated the concerns of small businesses regarding the problems of unfair competition from Government and nonprofit sectors engaged in commercial activities.

We have attached a current BCFC membership list which accompanies our complete statement, and I would request, Mr. Chairman, that our complete statement be admitted in the record at this point.

Chairman BILBRAY. Without objection, all the complete statements will be put into the record and all of you may summarize because the entire record will be in there.

Mr. SANTINI. Thank you.

As you recall, last year I spoke to the subcommittee representing the National Tour Association, a member of BCFC. I spoke about a group tour industry's specific problems with unfair competition from both tax-exempt nonprofits and the Federal Government.

Today, I am providing a brief overview and examples of expansive unfair competition problems the BCFC membership has experienced from both governmental and nonprofit sectors.

I will also conclude, Mr. Chairman, with some very specific recommendations for your consideration at the end of my statement.

The major advantages for subsidized competition varies. But here is a list of some of the privileges that Government and nonprofits enjoy when they engage in commercial activities: They are directly funded by the public in the case of Government competition. They are exempt from Federal and State income tax. They are exempt from property tax and often exempt from State sales tax. They enjoy postal rate discounts and special dispensation from the Federal Government's rules and regulations on antitrust, copyright, wage, unemployment insurance, and similar laws and regulations with which the nonsubsidized commercial entities must comply. Some receive and are eligible for grants, Government grants, and similar funding mechanisms.

Finally, I think all would concur, this is an obvious "halo" advantage, a very real marketing and perception advantage in doing

business with the public whether you come from the perception of a small nonprofit organization or a large nonprofit organization.

When we look at unfair competition from Government, we often see Federal officials decide to use existing facilities to generate dollars in competition with for-profit, tax-paying businesses or attempt to continue using a facility during a time of downsizing.

The Government is responsible to the public for performing inherently Government-related functions and national security negotiating with foreign Governments, governing and lawmaking and protecting the health, safety, and welfare of our citizens.

Based on the actual experience by our BCFC membership here is a short list of industries that encounter competition from Government: Bus and group tour companies, engineering and professional scientific services, data processing, retailers, campground owners, sleep product manufacturers, and the textile rental companies.

It is a broad-based problem exacerbated by established functions within the Government which compete with the very industries that generate the tax revenues and resources for this Government.

The long-suffering argument, "it can be done in-house for less," is unsubstantiated. Mr. Chairman, there has been no serious account of the Government and economy's costs calculated to include the true cost of the Government overhead, growing bureaucracy, erosion of a stabilized private sector, and the loss of a tax revenue base.

Fundamental questions should be asked when a Government entity is offering goods or services. These questions include: Is it a goods or service mandate of governing? If it is a mandate, can the good or service be provided through the Government from the private sector?

If Government engages in commercial endeavor, how many businesses will lose their business? How much annual revenue will be lost by a business?

How much tax revenue will the Government lose? How many jobs could it cost?

Or if the service and goods are provided by the private sector, how much tax revenue will be gained? Could jobs be created in small business?

Will Government benefit by simply acting in an oversight capacity rather than an acting capacity, thus reducing bureaucratic organization?

A brief tour industry example illustrates some of the current trends and problems we are having with some of our more adventuresome friends in the nonprofit environment.

I know I have that example here somewhere, Mr. Chairman.

Here it is.

We have a very enterprising exercise going on in Philadelphia, Pennsylvania, that operates under the title of the Lively Arts Group Tours.

Now, the Federal Government, at least IRS has endeavored through a Federal Technical Advice Memorandum—and it is just that, "advice," it is not precedent—but here is what the Federal Government has said when we are dealing with unfair competition in the educational arena: The IRS issuance of factors that must be

established to determine whether or not the business activity of the—tour operator, in this case—nonprofit entity is related to their educational purpose. A bona fide educational methodology that includes studies, reports, lectures, library access, reading list, and mandatory participation.

Second, the tour is conducted in a highly professional manner, with daily lectures and related classroom studies.

Third, the tour is arranged to allow participants to perform an intensive study of the subject and receive academic credit from a college or university.

The tour is selected for its educational value.

Our friends from Philadelphia have—they got a "historic Lewes-Rehobeth Seashore at Delaware Bay. Historic buildings." Little reference to the educational direct access.

"New York, on your own. Take a bite out of the big apple." Again little reference to the academic agenda going on there.

"Maryland's nostalgic Eastern Shore and cruise. Stroll through Oxford and St. Michaels and see Revolutionary shipbuilding." I guess a stroll could be educational in the generic, hardly in the academic.

It gets much more interesting. "A whale of a tour to the Hamptons, Long Island, Tuesday through Friday, June 14 through 17. The haughty Hamptons, a millionaire's playground." You have to go up and get educated about millionaires and how they play. "Pamper yourself on the first Sunday through Thursday, August 14 through 18. We research 20 spas and ask for recommendations of Fodor's healthy estates."

"The gracious Greenbriar," we all love the Greenbriar. "Thursday through Sunday October 27 through 30." You owe it to yourself to experience at least once this renowned resort in secluded West Virginia. A tax-exempt educational operation in downtown Philadelphia.

It cannot be debated that competitive advantage accrues to a cultural arts organization that runs these tours tax free against those who pay taxes. It is estimated that 25 to 30 tax-paying companies that operate in the Philadelphia metropolitan area provide these services.

Why should this so-called "cultural" endeavor be entitled to subsidizing? Why is it not simply a taxable enterprise in its entirety?

Under current law, we end up debating whether the device that is supposed to level the tax income end of the playing field, the unrelated business income tax, the UBIT standard that you referred to in your opening remarks, Mr. Chairman, applies. If it applies to those activities, really the commonsense conclusion is this activity should not be subsidized at all.

Regularly we hear that it is inappropriate to tax the profitable sales of an overall nonprofit organization similar to a for-profit business because of the essential difference of their motives, use of profits and so forth.

This gets us back into the point that the ends do not justify the means. First, a tax on profits does not eliminate in any way the ability of the nonprofit to continue funding charitable incentives through the sale of goods and services on top of their donor base or other funding.

Second, this approach ignores that all these subsidies are privileges. They are not rights—define rights, not theory—and should be controlled as scarce Government resource.

Third, the argument misses the culture that comes from the for-profit marketplace. We all saw this in the recent fiasco just across the river with the compensation benefit package allowed to the United Way, Mr. Chairman. This growing high compensation phenomenon within the nonprofit sector is a logical outgrowth for the for-profit motive, as the Philadelphia Inquirer in part 5 well describes the culture that goes on. Pay and perks like these have grown over the past few decades as nonprofit institutions have grown at a rate four times—four times the rest of the economy.

Nonprofits now control assets worth at least $850 billion. The growth of the nonprofits has created more than 3 million jobs, good, at a price. The economic transformation has cost the Federal and State Governments and ultimately the taxpayers more than $36 billion a year in lost taxes. That is the Philadelphia Inquirer, and if you can't believe them, who can you believe?

Thus what used to be a balanced situation of donations and expenditures out of public purposes and nonprofits has now shifted to an entirely unbalanced situation of more dollars in the form of for-profit ventures and more dollars out of much more compensation, et cetera.

The tax dollar should be paid so that the same relative circumstances prevail whether or not they are chartered as a nonprofit. Once the donative realm is vacated by the nonprofit, the same standards should apply as they do for a for-profit company.

Mr. Chairman, the IRS has estimated that over 1 million tax-exempt nonprofit organizations now exist and more than 40 percent are 501(c)(3). The revenue-producing level of all these entities is now approaching $500 billion annually.

The most recent GAO study, February 1987, on tax-exempt organizations competing with the small business community included at pages 20 and 21, the following: They are diverse and have significantly increased in terms of the number of organizations, statutory exempt categories, and types of activities and resources.

Second, they are dominated by Section 501(c)(3) organizations such as those engaged in charitable, religious, educational, and health activities with a small number of large organizations controlling a majority of revenue.

Third, rely on various sources of revenue to finance activities.

Fourth, has been to our point here in your hearing, Mr. Chairman—it is increasingly reliant upon income-producing or commercial activities as the primary source of revenue.

To address these fair competition issues, BCFC has four specific recommendations for you, Mr. Chairman, in conclusion.

First, we would request that you consider introducing a Sense of Congress Resolution that is the desire of Congress to rely on the private sector to provide goods and services to the American people and that the Government should limit its activities in all areas that are in competition with the private sector.

Second, Congress should ask all the affected parties, Government employees, charities, and trade associations, and large and small businesses to take a hard look at the roles and responsibilities of

Governments, of nonprofits, of commercial businesses in offering goods and services in commerce. BCFC recommends the establishment of a Federal advisory committee, a fact that would create a consensus-building environment to evaluate the service provided to society by these different factions and the responsibilities and objectives that must be met with any special Government or Government-endowed status or public support.

Congress should require a report from the FAC in 18 to 20 months and use the findings to craft legislation that would delineate the roles of the Government, nonprofit and commercial organizations, and establish a fair system of compliance.

Third, to complement the activities and other congressional examination of the issue, BCFC also requests that at least two GAO studies—and this dovetails with your own suggestions at the outset of this hearing, Mr. Chairman—an update of the 1987 GAO study; B, to complement Vice President Gore's "National Performance Review," we recommend a study of Government entities offering goods and services that are available in the private sector.

Finally, Mr. Chairman, number four, BCFC urges the Congress to move forward on legislation to implement the recommendations contained in the above-described report of the Ways and Means Oversight Committee. Specifically, BCFC is most interested in the provisions that would expand access to the IRS Form 990 that is now ostensibly available to the public but sometimes difficult to disgorge, and that would—and recommend a general increase in the penalty for failure to file a timely, completely accurate 990.

We believe these provisions would greatly enhance the tax-paying business sector's ability to serve the public as a watchdog with regard to the nonprofit business activities of tax-exempt organizations.

Thank you again, Mr. Chairman for this opportunity to present our views.

Chairman BILBRAY. Thank you, Mr. Santini.

[Mr. Santini's statement may be found in the appendix.]

Chairman BILBRAY. Mr. Weinberger.

TESTIMONY OF ALAN D. WEINBERGER, COMPUTING TECHNOLOGY INDUSTRY ASSOCIATION

Mr. WEINBERGER. Thank you, Mr. Chairman.

It is an honor to appear before the subcommittee to present testimony on certain issues of unfair competition.

My name is Alan Weinberger, and I am the chairman and chief executive officer of the ASCII Group, Inc., and it is incorporated in Maryland, founded by myself, actually, in 1984. My company is one of the largest chains of independently owned computer dealers or resellers, is the term of art used in the industry—of microcomputer equipment, hardware, software, peripherals.

We sell over $4 billion worth of computer products throughout the United States with over 700 independent computer dealers in the group.

I also chair and have the privilege of serving as Chairman of the Public Policy Committee of the Computing Technology Industry Association, CTIA. It is the industry trade association for the PC industry. It is a nonprofit trade association representing over 3,000

companies for all segments of the industry, all the major manufacturers, distributors, software publishers, and resellers and associated service companies.

An open market and free competition is essential to this industry. Everybody knows it almost reinvents itself every 18 months. CTIA believes that fair competition is more than just a theoretical or abstract concept found in textbooks. Fair competition is or should be the controlling parameter to which we all subscribe.

Specifically, CTIA is concerned that certain nonprofit associations and organizations properly exempted from taxation under the IRS are improperly permitted under their tax-exempt charter to market and sell computer and related products unfairly.

In essence, a for-profit computer reseller is the average computer reseller from Main Street to Wall Street around the States and a nonprofit computer reseller can be located next door, have the same look and feel, market the exact same products, provide the exact same service and warranty work, and advertise the same products next to each other in your daily newspaper. The only difference is that the for-profit resellers pay corporate taxes and other taxes and the nonprofits do not. We do not believe that that represents true and fair competition.

In many but not all cases these nonprofit computer resellers are college and university bookstores which may or may not be owned by the university or at least licensed by the university.

However, these bookstores, as everybody knows, do not just sell to students. In reality, they can sell to almost everybody in the United States. A clear abuse.

To illustrate the impact of this unfair competition, I would like to offer several examples to this subcommittee.

In reviewing these examples of unfair competition, it is important for the subcommittee to understand how vastly different the prices for the same computer can be between a for-profit and a nonprofit. As a result of special purchase agreements by manufacturers under exemption from the Robinson-Patman Act for nonprofit entities and the exemption from Federal and State taxation as a for-profit business, college and university bookstores that market and sell computers and related equipment, these nonprofits, these colleague university bookstores can, in may cases, offer goods for sale at retail—computer products—that are much less than the wholesale cost of these exact same goods from the for-profits.

When considering the full cost of computer systems, the difference can be in the many hundreds of dollars. Multiply this by about 3,000 bookstores around the United States and the cost of uncollected taxes runs into the many millions and the unfair sales into the pockets of these nonprofits into the hundreds and hundreds of millions, and it really takes away the sales from the for-profit tax-paying entities which are the wholesalers and retailers, and of course the manufacturers are involved, too.

Some examples. A reseller in Ann Arbor, Michigan, has been effectively closed out of the retail market because of price pressures from the University of Michigan. An ASCII Group dealer, Showcase Software in Freeland, Michigan, has lost numerous sales on this price differential to the University of Michigan, Morehouse State, and Michigan State.

Another one of our resellers in Kansas estimated that their sales dropped 91 percent when the University of Kansas bookstore began to market and sell computer products in competition with them.

Specifically, an ASCII Group dealer, Grafico, Inc., in Baltimore, Maryland, is not able at all to compete in the market in competition with the University of Maryland.

When contemplating these examples, it is important to note that every sale of a computer or computer-related equipment reduces the income tax revenue stream from the nonprofit.

When the bookstore lowers their prices to beat the for-profit reseller and maintain their price differential if necessary, tax revenue is further reduced. The pricing cycle goes down and down and down and until obviously the for-profit just exits the market and at that point, the nonprofit can in effect, set an established price. So, there is no price competition.

Customers bring in products purchased from the nonprofit resellers to the for-profit resellers to perform warranty work. Thus, not only is it nearly impossible to compete on the sale of goods, but the for-profit resellers serve as unpaid sales consultants or under contract from the manufacturers as an authorized dealer and, in effect, as a service center for the goods purchased across the street from the college bookstore.

Here is one of my key points, and I think if we focus in on this we will really see what we are talking about. School books and computers are very different. Course books are used only for a term or two and have really a limited use thereafter. A course book is usually prepared by a professor really just for one course.

A computer is more like an automobile as far as the utility for a student outside of a particular class. Especially for his or her life thereafter, that is thereafter the class. It is really the vehicle of travel along our burgeoning superhighway, the superhighway which of course the Department of Commerce has set up an advisory council and Vice President Gore is very interested in having a competitive advantage for the United States internationally on this, the whole information interchange superhighway. So, the computer is the vehicle of travel along this superhighway.

No one in this subcommittee would suggest that college bookstores should sell automobiles at unfair prices which would hurt independently owned auto dealers, so why do they have the right, in effect, to do that with computers?

Mr. Chairman, in conclusion, the CTIA and my corporation the ASCII Group believes that unfair competition between for-profit computer resellers and bookstores that market and sell computers and computer-related equipment must be resolved. We are certainly willing to work with the Congress, the subcommittee, and any private groups to shape a constructive examination of the entire subject and to begin to shape the framework for resolving this clearly unfair competition issue.

Again, thank you for permitting me to appear today.

Chairman BILBRAY. Thank you Mr. Weinberger.

[Mr. Weinberger's statement may be found in the appendix.]

Chairman BILBRAY. Mr. Applebaum.

TESTIMONY OF DAVID APPLEBAUM, PRESIDENT, YOUNG LAUNDRY AND DRY CLEANING, REPRESENTING THE TEXTILE RENTAL SERVICES ASSOCIATION

Mr. APPLEBAUM. My name is David Applebaum.

I am president of Young Laundry and Dry Cleaning located in Honolulu Hawaii. I am testifying on behalf of the Textile Rental Service Association of America, which represents over 1,100 member companies.

The textile rental and linen supply industry is made up of for-profit companies that provide textile maintenance service for commercial institutional and industrial accounts. Our companies rent and service hygienically clean textile items to virtually every type of business in America with major emphasis on the health care industry, hotels and restaurants.

I commend this subcommittee for holding these hearings, and I appreciate this opportunity to testify.

I believe it is critical that Congress be made aware of how the nonprofits have damaged the textile rental industry as well as others and how their tax-exempt status continues to erode the tax base. It does that not arithmetically but geometrically, it is getting worse by leaps and bounds.

My testimony today will focus on my own company and the damage I have suffered as a direct result of the nonprofit hospital industry and provide some recommendations.

I have included in my written testimony some background information on nonprofit hospitals' tax-exempt status and our laws are current do not adequately define a charitable organizations mission in the context of today's health care industry.

My story begins in 1985 when Kuakini Medical Center's 250-bed hospital took the Convalescent Center of Hawaii account from me. That account ran $10,000 a month and Kuakini's price was 40 percent below mine.

In the following year, Queens Medical Center, a 503-bed teaching hospital took the Kaiser Hospital account from me. This account ran $35,000 a month and again their prices were 40 percent below mine.

In both instances, the 40 percent price differential was astounding considering that my pretax earnings at that time were running about 5 percent.

At that time, I went to both hospitals during that 2-year period and I complained bitterly that they were selling below their cost. Grossly unfair. Both assured me that according to their own cost schedules, they were not selling below their cost and it was at that time that I first became aware of the advantages the nonprofit hospital has.

In my opinion, they are truly a Government-subsidized competitor because: Their tax-exempt status allows them to ignore Generally Accepted Accounting Principles when calculating their costs, to raise cheap money via tax-exempt bond issues; avoid income and property taxes; enter into unlimited unrelated business ventures as long as they pay taxes on their income-producing activities which, by the way, they have managed to avoid by shuffling stuff around.

Nonprofit hospitals only provide limited charity care; the average charity care nationwide provided by hospitals today is 6 percent of their expenditures.

They operate at a profit above their cost of doing business since they are reimbursed for over 90 percent of their services rendered through insurance, Medicare and Medicaid, social security disability and the taxpayers.

They are allowed to set prices without considering the value of the fair market value of the assets employed because they have donated land, building, and equipment.

In 1991, Queens Medical Center built an off-site facility that contained significant excess capacity over their own requirements. The laundry was built on donated land and the building and equipment were financed through tax-exempt bond issues. I made a fuss at that time.

Queens maintains that they did not use any of the bond proceeds for the laundry. That is no big deal, the tax proceeds served a purpose of freeing up other cash which they used to outfit their laundry, and it is my opinion that the other cash is a charitable asset just as much as tax bond proceeds and should be subject to the same restrictions.

From the date the laundry was completed, Queens began to operate in the commercial market. They actively solicited and won business from me, hospitals, nursing homes, laboratories and other health care facilities. They continued to deeply discount their prices, despite the fact that now they were off campus. They were located in a brand new multimillion dollar facility located in an expensive industrial park, outfitted with very expensive state-of-the-art laundry equipment.

If my company were to provide the services that Queens Medical Center is providing at the prices they are charging, I would not have enough revenue to cover my cash costs let alone anything for overhead.

Part B of this saga began in 1988, a consortium of four entities funded and formed a private corporation called United Laundry Service. These owners are Kuakini Medical Center, St. Francis Medical Center, Kapiolani Medical Center for Women and Children, plus a private individual. The United Laundry Service bought land, erected a building and installed very expensive state-of-the-art equipment, away they went. They took the rest of my health care business that Queens somehow had forgotten to take away from me at deep discount pricing.

In 1991, United sold a fifth of itself to a major hotel chain which was my customer in exchange for that hotel chain's business. I suffered another huge loss.

In 1992, United Laundry sold a sixth of itself to a second hotel chain, again my customer and again another huge loss.

In sum, these two laundry plants owned by nonprofit hospitals have taken $10 million in annual sales from me or 40 percent of my business.

In contrast, all this time, I have had to find money at prevailing rates to buy land, building and equipment. I have had to hire competent staff to manage our affairs so that we are competitive in the

marketplace. Throughout this entire period, I have made a profit, and I have paid my taxes.

I have been subject to financial ruin, because as a private businessman, when I could get credit, and sometimes it was very iffy, I had to guarantee the debt with my personal assets.

It is difficult for me to understand how a charitable organization with the tremendous advantages they have is allowed to invade my business. Not only did they take the health care business of which I was the major vendor in the city and county of Honolulu, but they are also in the hotel and restaurant business which is entirely unrelated to their mission.

Finally, the continued tax exemption of the nonprofit organizations serves to erode the tax base by moving business from the tax-paying sector to the nontax-paying sector, although they are required—nonprofits are required to pay taxes on unrelated business income, that hardly ever happens.

They are, through creative cost shifting, able to avoid most income taxes. This continual shift is causing a huge reduction in the tax base.

If you would kindly look at the schedule I had included in my written testimony, you will see that this happens geometrically.

I recommend that the definition for tax-exempt status be redefined. The original deal that led to granting a hospital tax-exempt status was that the hospital would provide charitable services that the Government would otherwise have to provide and operate on a nonprofit basis.

I don't think it was designed to give the hospitals tremendous advantages to compete with the private sector. I recommend that all nonprofit hospitals should be prohibited from engaging in commercial activities, period.

They definitely should be prohibited from serving nonhealth care customers from their own facilities or their shared facilities, and should be prohibited from serving health care customers when there are adequate commercial services available.

I recommend that nonprofit hospitals be limited as to the amount of the income they can have from all sources. Most of your nonprofits have substantial private foundations and separate organizations , neither of which never appear on their annual reports.

I would recommend that all income from all their sources be limited to, for example, 10 percent above all of their expenses from all their activities, and the minute the income rose above 10 percent of costs, they would have to lower the cost of a room or surgical procedure until the income dropped.

Finally, I recommend that the IRS be forced to ensure compliance, which they don't do now for a whole host of reasons, but the fact is that the nonprofit hospitals operate virtually untouched, unaudited and unbothered by the IRS.

That concludes my testimony.

Thank you.

Chairman BILBRAY. Thank you Mr. Applebaum.

[Mr. Applebaum's statement may be found in the appendix.]

TESTIMONY OF JOHN McCARTHY, IRSA: THE ASSOCIATION OF QUALITY CLUBS

Chairman BILBRAY. Mr. McCarthy.

Mr. MCCARTHY. Mr. Chairman, ladies and gentlemen, my name is John McCarthy. As the executive director of IRSA, the Association of Quality Clubs, I am privileged to be here today on behalf of more than 2,000 member clubs, all of which are required to abide by the association's baseline standards and code of conduct, and most of which are involved in charitable activities within their respective communities. Among the most notable of these activities are the "Adopt a School Program," which was developed by IRSA, and our national program to make our member clubs "Special Olympics Training Centers."

Yes, all of our members pay local, State, and Federal taxes. Every one of these clubs competes on a day-in day-out basis with tax-exempt competitors, such as YMCA's, JCC, and to reinforce Mr. Applebaum's point, with nonprofit hospital health clubs, as well as tax-spending competitors like park and rec fitness and athletic facilities.

May I present 94 brief examples, 3 of which illustrate the damage that tax-exempt competitors inflict on tax-paying facilities, and the fourth depicting how little charitable activity some of these tax-exempts actually provide their respective communities.

Frist, in Salisbury Maryland, 15 years ago, a former high school teacher and coach started a tax-paying, racquetball and fitness club. Two years ago, a $2 million YMCA entered his market, built largely with tax-deductible donations, and he lost 33 percent of his membership. Now that club struggles to survive.

Second, I present an example which was chronicled in an article in the Journal of Philanthropy. In downtown Oakland, California, the O'Connell family had operated the Executive Athletic Club since 1936. Four years ago, an $8 million YMCA opened within a few blocks of this club. Within a year, the business which had served the same neighborhood on the same block for more than 50 years was closed. Mr. O'Connell, who before had characterized himself as a lifetime supporter of the YMCA, now calls the Oakland Y the "Yuppie Men's Cash Association."

Third, the Park and Rec Department of Tucson, Arizona, recently opened a $4.5 million athletic center with an indoor pool, college-sized gym, racquetball courts, and fitness facilities. Within 18 months of the opening of this facility, one of our members, Jim Halkemeyer, had to put his once thriving business into bankruptcy.

Fourth, an example of how little community service some tax-exempt health clubs actually provide: Recently, when the Supreme Court of the State of South Dakota ruled that a $6 million, hospital-owned health club in Sioux Falls, South Dakota, was not entitled to the tax exemptions that it wanted, the court did so on the basis that only one-half of 1 percent of the club's 2,600 memberships were in any way subsidized by the hospital. As the court said, the legislature did not intend to give tax exemption for "splash-parties" to affluent customers.

Mr. Chairman, I have estimated for the record—and this reinforces what some of these gentlemen have already said—that on average, a tax-exempt facility enjoys anywhere between a 16 per-

cent to 30 percent cost advantage over the neighboring tax-paying competitors. As anyone familiar with business will tell you, a 16 percent cost advantage compounded year after year is all but insurmountable.

The dynamics of competition between tax-paying and tax-exempt facilities in our industry provides the tax-exempt operator with an enormous competitive advantage that is driving investors and capital out of an industry that could otherwise be a normal growth industry in this country.

Finally, point I wish to state with special emphasis: What we have observed with rare exception in community after community is that the tax-exempt operators—whether YMCA's, JCC's, or not-for-profit hospitals, or even parks and recs organizations—no longer build their facilities in communities where there is genuine need, but rather almost exclusively in affluent areas that are already served, or can be served, by the private sector.

Let me give you but one example: 15 years ago, when the neighborhood of Brooklyn Heights, New York—an area that many of you are probably familiar with—was rapidly deteriorating, the YMCA in that community closed its doors, while the St. George Health Club stayed open. Now, with Brooklyn Heights rapidly and dramatically gentrifying, the YMCA is looking to reopen its facility.

To all of you who are familiar with the Washington, DC market, I say simply that the National Center YMCA is exhibit A.

Further, as you know, it is the Federal tax-exemption that triggers exemption from State and local taxes as well. An organization's Federal tax status normally ensures that the organization will pay no property taxes, no sales taxes, and no State income taxes.

As a result of this ever-growing, tax-exempt sector, every taxpayer, whether an individual or small business, pays more. In our community of Boston and Cambridge, 30 percent of the property is owned by tax-exempt organizations—much of it by some of the wealthiest institutions in our country.

In conclusion, I want to make three imminently reasonable recommendations: First, I want to endorse Mr. Santini's call for a congressional resolution delineating the proper and appropriate role for the provision of goods and services by the public sector and by the not-for-profit sector, and for the creation of a Federal advisory commission to draft legislation to deal with this problem.

Second, I recommend that this committee require the executive branch to develop hard and fast estimates on tax revenues actually being lost because of abuse of UBIT legislation, as well as studies that quantify the extent to which not-for-profit health clubs and other businesses in comparable industries actually serve those in need.

Finally, I urge this committee to adopt a bright-line test, rather than the current amorphous and unadministrable community-benefit test, to ensure that tax-exempt fitness clubs pay their fair share of taxes. We have submitted, as part of our testimony, legislative language for such a test.

Thank you.

Chairman BILBRAY. Thank you, Mr. McCarthy.

[Mr. McCarthy's statement may be found in the appendix.]

TESTIMONY OF F. DEWAYNE FOSKEY, NATIONAL CHILD CARE ASSOCIATION

Chairman BILBRAY. Mr. Foskey.

Mr. FOSKEY. Mr. Chairman, thank you for the opportunity to appear before you today on behalf of the National Child Care Association, NCCA. My name is Dewayne Foskey, and I own a chain of licensed private child care centers in south Georgia and in the Atlanta area.

As a board member of the National Child Care Association and an owner highly impacted by the inequities of Government and nonprofit competition, I have been asked to bring the concerns of this vital industry to your attention.

The National Child Care Association represents the largest single provider of early childhood care and education in the Nation: Namely the private sector. Most members of NCCA are tax-paying, not tax-consuming, small business proprietors of single center operations.

It is important to understand that we are the classic small business. Only 9 percent of the available child care in this country is provided by the large chains.

I would like today to focus on the inequities created by nonprofit competition which is prevalent throughout our industry. I think it is best today to take this opportunity to acquaint you with the very serious problem that confronts us, a problem that we cannot fix without your help.

I believe our situation is perhaps different from the other scenarios that you are considering here this morning because it is not blatant competition but it is subtle and insidious competition.

Our competitors are successful because it offers a service at little or no cost to the individual but at the expense of the taxpayer. Our competitor has access to a captive market and that is locations that are convenient and trendy today.

Our largest single Government competitor are our Nations public school systems. While struggling to do their primary job adequately, the public school systems are literally putting themselves in the child care business. They are openly boasting of making profits and backed by tax subsidies are successful despite the level of service that they provide and the lack of minimum of health and safety regulatory compliance.

I would like to share with you just a moment a personal scenario that involves my own company, Children's Friend, our company owns and operates 28 early childhood care programs in Georgia. Twenty-five of those provide early care as well as school-age care. Three of our programs are dedicated strictly to school-age care.

Children's Friend was founded in 1976 with a corporate commitment to bring quality, affordable care to south Georgia, which was underserved at the time. Today's Children's Friend has grown steadily in south Georgia but the competition from public school-based care, after-school child care programs were not a factor in our business plan and decisions back in 1976. But circumstances have certainly changed since that time. Now my company's ability to grow has been compromised by the public school-based child care programs.

In 1990 and 1991, two programs in Columbus Georgia were operating at full capacity caring for a total of 365 children. Over 150 of these being school-age children. Our decision to expand our facilities at one site to accommodate a parent need and demand was a substantial financial commitment for our company. But we made it based on the study of the data and what we perceived and understood to be the need.

In 1992, nearby public schools announced that they would be opening after-school child care programs. Today at Children's Friend 2 years later, we have not recovered from the loss.

By the way, now we only have 250 students at these two sites and a new building that we are unable to use. There was an almost an instantaneous loss of 150 school-age children overnight.

Children's Friend is behind today $200,000 in annual revenue on these two programs alone. We have been unable to rehire the 10 staff members and teachers we were forced to release. Although it has been difficult, we have been fortunate enough to spread this loss over our company base.

I do not know of a single center operator today that could survive this kind of impact on their business. Now data is beginning to be gathered to show that they are simply not surviving.

Because small business is known for its problem-solving capability. I would like to suggest to you today some solutions for our dilemma. The first is that equal protection of all children be a national State and local policy priority. We believe that minimum health and safety standards should be applied to all out-of-home child care programs, regardless of their tax status and how they are operated. The vast majority of public school-base programs are not licensed.

Our second recommendation is that nontraditional public school programs must concentrate on at-risk children as their first priority. The Government which is responsible for tax expenditures should encourage public schools to concentrate their child care programs on at-risk children first. Only if quality child care is not available in the private sector.

In closing, the bottom line is this, Mr. Chairman: Do we really want child care, childhood care and education to be the next entitlement program for the United States? If the answer is no, then Congress needs to act now to redirect the early care and education in our country.

If the answer is yes, then get out your checkbook. Prepare ourselves for gigantic increases in the demand for child care through school systems. In this scenario the private sector industry will continue to decline and eventually the only option parents will have is care through public education.

Thank you, Mr. Chairman. I thank you for this opportunity.

[Mr. Foskey's statement may be found in the appendix.]

Chairman BILBRAY. Mr. Doherty.

TESTIMONY OF RICHARD DOHERTY, PRESIDENT, COMPREHENSIVE HOME HEALTH COMPANY, NATIONAL ASSOCIATION FOR MEDICAL EQUIPMENT SERVICES

Mr. DOHERTY. Mr. Chairman, members of committee, on behalf of the National Association for Medical Equipment Services,

NAMES, I am pleased to have the opportunity to comment on the issue of unfair business practices within the health care system.

My name is Richard Doherty. I am president of Comprehensive Home Health Co., Avon, Massachusetts, a small business, and immediate past chairman of the National Association for Medical Equipment Services.

The NAMES membership comprises over 2,000 home medical equipment companies which provide quality cost-effective medical equipment services and rehabilitation/assistive technology to consumers in the home. These companies take pride in providing personal comprehensive medical equipment services in the setting where the vast majority of individuals prefer to recuperate, the home.

Home medical equipment consists of basic aids for daily living and a vast array of highly specialized and advanced services such as infusion therapy for the provision of antibiotics and chemotherapy, oxygen and ventilator systems, wound care and ostomy supplies, and advanced rehabilitation equipment and assistive technology.

Specifically, the home medical equipment services industry is concerned about two issues: One, consumer choice of health care providers under National Health Care Reform and more importantly, the growing proliferation of nonprofit hospital ownership of home medical equipment companies, creating the classic example of a captive referral situation.

NAMES maintains that all Americans should have the freedom to choose their health care providers under the administration's Health Security Act. Health plans theoretically could contract with just one provider in a given field to provide the appropriate care.

Such a practice would limit the choices of available providers from among which consumers could select. Under such a practice, home medical equipment suppliers from whom consumers already have received prior care or whose companies are closer to the home, could be closed out.

The provider of these services would, in many cases, be the nonprofit hospitals.

Home medical equipment suppliers strongly support the following freedom of choice principles: No provision in the final health care reform plan should be constructed to allow monopolization, attempted monopolization, conspiracy to monopolize or other restraint of trade prohibited under the existing antitrust laws.

Any proposed health plan must select participating providers through a competitive process using objective criteria including quality, price, service, and patient satisfaction. Publish a description of any competitive selection process in advance to permit all interested providers a fair opportunity to participate.

States may not limit or prohibit competition among providers to participate in the health plan by granting any antitrust exemption.

The second issue which we are concerned with is the acquisition of home medical equipment companies by nonprofit hospitals. In recent years, many nonprofit hospitals have established or acquired home medical equipment companies, ostensibly to provide "one-stop shopping" for people who are being discharged from the hospital.

On the surface, such a concept may sound like a more simplified cost-effective approach to administer health care. This approach which aims to eliminate the confusing bureaucratic maze and paperwork patients face when coping with a post-acute medical episode, could appear attractive at first. Yet, it has not taken long for many health care providers to determine that such vertical integration is not as wonderful as some claim and, in fact, has led in essence to a captive referral situation.

The following problems either exist today could occur for consumers, Government agencies, home medical equipment suppliers, and local communities due to hospital ownership of home medical equipment businesses.

Nonprofit hospitals may refer patients to their own home medical equipment companies, wherever one exists, without the patient having knowledge of other options. In other words, patients would not be provided with a choice of provider.

Where a pretense of choice does exist in reality, there is no choice. The patient has no preferred provider and will always go with the hospital in which they trust.

The hospital home medical equipment companies could drive existing independent home medical equipment suppliers out of business, thereby creating a monopoly situation that would allow hospitals to control the home care marketplace, eventually patients would have no choice available to them.

Continued "self-referral" of Medicare patients could cost the Government more money in the long run. Similar to the problems that occurred with physician self-referral under Medicare.

Private-pay patients who belong to a hospital-run health plan and are referred by the hospital for home medical equipment services could receive reduced care in order to allow the hospital to lower costs and save money.

There would be a loss of tax revenue as well as jobs within the community if nonprofit hospitals eliminate for-profit, independent home medical equipment companies.

The hospitals traditionally have enjoyed a special position within the community, based on trust and benevolence and hence their nonprofit status. NAMES recommends that Congress guarantee real consumer choice in any health bill passed this year and that they closely examine the relationship between hospital-owned and independently owned ancillary services to determine the problems associated with this type of service delivery system.

Studies such as those that the GAO conducted on physicians self-referral arrangements are a good place to begin such an examination.

Again, thank you, Mr. Chairman, for an opportunity to testify today.

Chairman BILBRAY. Thank you, Mr. Doherty.

[Mr. Doherty's statement may be found in the appendix.]

Chairman BILBRAY. I recognize my colleague, Mrs. Clayton, has come in.

I don't know if she had an opening statement.

Mrs. CLAYTON. I do not.

Chairman BILBRAY. All right, at this point I will start the questioning and then turn it over to my colleague.

Mr. Santini, you mentioned the particular travel company in Philadelphia area. I was curious that we see this, like I mentioned, 1,100,000-plus nonprofits in the country, and on top of that, that does not include the 340,000 churches that are also tax exempt. This type of organization, does it have an ultimate end charity that it belongs to, and does its profits go someplace; or do you know anything about this group? Because I am curious, it seems like more and more groups are setting up nonprofits just to conduct business, and that as a kind of a side effect, if they can generate some sort of profits for somebody or some charity, that gives them their tax-exempt status; is that what it is?

Mr. SANTINI. That is a good question, Mr. Chairman, and we have looked at 3 years of their required filing of the public information form 990. There is no evidence contained in those filings that suggest that in any way, the profits derived by this nonprofit from the group tour's daily and extended excursions are in any way reinvested in the community in any charitable enterprise other than programs and the salaries of those employed by the nonprofit in running tours.

Chairman BILBRAY. That has been a very big problem.

To be honest with you, just recently I first looked at this form, this IRS form, and I am sure all of you are familiar with this. This is the entire section that talks about related activities. If you know how you file your tax return, and mine is just an individual tax return, I have—certainly there is not much that can be put in there, and it really concerns me. That is one of the things we want to look at is the fact that when you think about 1 nonprofit for every 200 people in the United States, it becomes an alarming figure.

We do have the Ways and Means evidence, the fact that it is costing a minimum of $36 million a year in lost revenue, that probably are from nonprofits that are actually deviating from their original goals.

Do any of you know that when any of the nonprofits come into competition with you, whether or not they ever do any sort of survey work or any sort of analysis of what their effect would be on the community and on the profits?

When a business goes into an area, usually you try to look at it and see what the need for that particular item is, or that particular type of business is, to make sure you don't open up a business in an area, and find out there are certain laundries in an area, and you are the 18th and there is not enough business for the 17th.

Have any of you have encountered where organizations have declined to open up because of the impact on the private enterpriser; is that just totally off the scale when they deal with it?

Mr. Weinberger.

Mr. WEINBERGER. Well, I think it is almost obvious in the computer area every—not everybody but many people have young children that have gone to colleges and other institutions and the college bookstores know that they sell many products to people who have no—are not present students at the university. They know that either that product is going to be bought from the independent computer dealer—for example, in Las Vegas we have a number of computer dealers that have been hit by the UNLV.

In Cambridge, in Baltimore, every place where there is a House Member in this panel, is a direct and immediate impact on the for-profit sector by these universities. So, it is just patently obvious on its face that they know that they are taking sales away from the private sector and they know the private sector cannot compete because of the exemption under the Robinson-Patman Act for special pricing by the manufacturers.

The Apple Program is notorious. We are not blaming the manufacturer, we are blaming the system.

Chairman BILBRAY. When I was State Chairman of the State Senate Committee on Taxation, we had the same problem with cigarette sales on Indian reservations. We interpreted the State law to mean the only people who were supposed to buy tax free were members of a tribe. Two incidents took place that made it very unpractical for us to try to enforce that rule; one, the Indians threatened to make everybody that came in a member of the tribe. Sign them up as a member of Paiute Nation.

Second, in one incident they surrounded the car of two of our tax people and went into an Indian war dance and threatened to take their scalps. Our investigators didn't want to go out there anymore or tax collectors. They at least believed they were very serious.

The question we have is, on students, of course, one of the things we can look at is the fact that when you have student facilities offering student discounts, I always thought that in most cases those sales were limited to people with student cards, but that is not the case, is what you are telling me.

Mr. WEINBERGER. I will give you one specific example. The Kansas Legislature under the States chief auditing agency—my assistant gave me this, the sales at the University of Kansas and Kansas State—and under the legislators auditing processes, they found at least 10 percent of the book sales went to personnel who had no relationship to the university. So, this is a specific example.

One faculty member at the University of Kansas admitted he bought four computers at bookstore and then sold them for a profit because he could undersell, so it is a daisy chain. It is almost like a kiting scheme, when you can buy computers and resale them and make a profit because you can undersell the computer stores.

Chairman BILBRAY. I remember when I went to the college in the old days, I went to UNLV and American University Law School, you had to show your student card at the bookstore to actually buy in the bookstore. But what you are saying is that either they are ignoring that or the student is buying it for the other people outside.

Mr. WEINBERGER. Right. Well, that goes into how we police that. But if a student shows a card day one, he can show it every day and buy another computer. He can buy 300 computers a year. In other words, it is not as if you were buying books. Who wants to buy more than one book for a college course, but you can keep buying a computer every day. Just show your card to another clerk.

Chairman BILBRAY. Yes, Mr. Foskey.

Mr. FOSKEY. To respond to your question about market data and whether they gathered that data and how they use it. It has been our experience in our State, and at least four different school sys-

tems I am aware of, that there has been a blatant disregard for the private sector.

They know and study the market data. They know the best opportunity for success in that. They establish their after-school programs in the predominantly affluent areas, neglecting the less affluent, those who really have the greatest need. Consequently, they focus where they can make the profit to generate the program and operate the program and pay the salaries. The response we have received in our State is: We know it is going to hurt you and we don't care. We are going forward with our program.

Chairman BILBRAY. Mr. McCarthy.

Mr. MCCARTHY. Mr. Chairman, I would like, if I may, to respond to the question you asked Mr. Santini about whether these charities give the money they make in these businesses to some charitable area. I think at least from our perspective, the courts have dealt with that issue. The destination of income is not what validates tax exemption.

You have probably read in the paper about Ben and Jerry's and how it gives 7½ percent of its earnings to charity, and about how McDonald's builds its Ronald McDonald's homes all over the country. Where the money goes is not what justifies exemption. What justifies exemption is that the acknowledged activity itself has to be essentially charitable.

I think what we are saying on this panel is that the activity which we are seeing is not charitable. The not-for-profit sectors are serving affluent classes, providing the same markets with the same services as the for-profit sectors; the activity is exactly the same as that which we at this table are offering but they are totally tax exempt.

Chairman BILBRAY. I see.

For my colleagues who came in late, one of the comments was that we will have testimony from the YMCA representative after this in the next panel.

Is the fact that YMCA's are now being built in upscale areas not in the lower-income areas, where traditionally I presume YMCA's were?

Mr. MCCARTHY. Yes, that is happening with YMCA's. That is happening with JCC's, too.

I think this panel will probably agree that hospitals are everywhere. They are in the laundry business and in the medical equipment business. And hospitals are now in the health club business, too. They are siting their facilities in the same way that for-profit entrepreneurs would site their facilities, going to the highest density market of the highest income people.

Chairman BILBRAY. Thank you.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman, I appreciate your calling this hearing, and have been conversant with some of the concerns coming from perhaps a little different perspective from some of the panelists in explaining my view of what drives this unfortunate circumstance.

On one hand, there are legitimate charitable activities who determine that there are needs in the community which are not being

met by the for-profit sector and determined that they should engage in an activity for those purposes.

Whether it is charitable or not, they get a basic Government subsidy in some form, lower tax rate, some assistance of some sort. Proceed to offer that service.

I, rather than looking at whether the activity is charitable or not, in warranting the special treatment by Government regulators, taxes, licenses or whatever, look at the actual service and whether it is needed in the community, and it is unmet by the private sector, is perhaps even a more difficult task to meet. But what I am finding is there are legitimate reasons for, say, a military facility which offers exemptions from local taxes in a small community, where if it is a video store rental area within the municipality, he pays one set of regulatory costs to operate.

If he moves across the line to the military installation, he pays a much lower cost of doing business and is much more convenient to the soldiers and employees of that military facility. So, you have an on-base facility then competing with the off-base facility.

Same exact situation, it is not charitable. What is driving that, and I think what may believe driving a lot of the organizational activities is pledging. The base commander in this particular case says: Look, Congress is not funding our operations at historic levels. We are looking for ways to generate money. This is one that generates it. There is nothing wrong with this and so we are going to do it.

I see a lot of that pressure in the charitable structure as a result of tax code changes, where business has got significant benefit from contributing to charities. Now they don't, and so charities are looking for a way to make up the money.

I think perhaps—and I would like to get Mr. Santini's comment and anyone else who would care to respond—that maybe what we need is without going back into tax code questions and whether charitable contributions are a good thing or not, is an ability for a local community interest to respond before a governmental subsidy, whether it is regulatory relief, tax code break, facilities, school buildings that is made available for day care, whatever it might be. Before that action is taken, that there is at least a public hearing and an opportunity afforded to the affected interests to state why this should or should not happen. That may be beyond Federal purview because many times it is a State or even municipal interest that is at risk and who should be conducting that process.

What I sense that is justifiable from your point of view is that these actions take place, there is no opportunity for you to be heard, the business interest is established, the revenues are generated, and once the money is made, not only is the business interest hurt, but once the revenue stream is provided, where do you replace it, if, in fact, you shut it down and there is a public interest in not harming a charitable activity.

Is the hearing process perhaps the most appropriate response, or what should we do?

Mr. SANTINI. Certainly, that would contribute to a substantial mitigation of at least informing the public of the gains and loss consequences of allowing a nontax-paying entity to engage in a for-

profit activity that is already being provided in the local community.

I like your idea from a pragmatic standpoint, in that it would invite in the local municipality, the county Government structure, if it pertains to the county, the school board, if it pertains to school board-related activity. The challenge we have in that context is that the political reality of apple pie, motherhood, and now the Mustang automobile perception that these charitable activities are inherently meritorious. They are. That any suggestion or questions that are raised about the propriety of that charitable activity engaging in a for-profit competition business is in somehow a condemnation, a criticism of the charitable purpose or function involved.

If we can get over that political perception hurdle, I think we could get a lot closer to an honest examination of the pros and cons that relate to the nonprofits that are exploding into the arena of for-profit business.

Mr. BAKER. I understand the concern, but the point of my question is that where you have a legitimate charitable activity in a poor inner-city neighborhood, where there is not an avenue to attract private capital, if you take the exact same operation and you move it into an affluent neighborhood, where it does, in fact, make a profit, the only difference in the two instances is the fact one works profitably and one doesn't.

I don't think a one-size-fits-all congressional rule would be fair in either circumstance. I think you have to look at the merits of each individual circumstance and make a judgment as to when is it right and when is it wrong. That is what troubling me about a congressional remedy to this.

Mr. APPLEBAUM. Excuse me, sir, I don't think, at least from where I sit, that is not my problem. If you have a purely charitable organization and it operates in several areas and maybe it makes money in one and loses money in another, I don't have a problem with that.

What I have a problem with is that purely charitable organization goes in an unrelated activity, unrelated to its mission. When a hospital opens up a commercial laundry and they—with the tremendous tax advantages they have and they begin to wipe out my business, that is where I have a problem.

Mr. BAKER. I disagree, because the point of a hospital opening up a laundry, if it was nonprofit, if it was charitable so the proceeds of that activity go to providing health care services in the community, has the same economic consequences on the for-profit laundry that is trying to compete with it as it would if it were a for-profit laundry.

If they are providing a service that is being provided by free enterprise, whether the proceeds, whether you call it "profit" or whether you call it "contribution," they are providing that service at a subsidized rate that competes directly with you. So, in my view, it makes no difference whether it is for-profit end result or charitable result, if they are competing with free market services where there is not a need for free market competition because it now exists without Government subsidy.

Am I making it clear?

Because they put you out of business either way. My view is that we ought to have a measure of some standard as to whether or not a Government subsidy or assistance to a particular operating entity ought to be granted when there is no demonstration of need in the community in which the Government-subsidized activity is to take place. That goes far beyond charitable. That goes to military installation.

Mr. APPLEBAUM. And speaking of that, I have 30 dry-cleaning stores in the city and county of Honolulu, half of which are on military bases. There is a substantial military population in Honolulu and I have lost about 12 to 15 percent of my military dry-cleaning business to exchange laundries. Exchange laundries owned by Marine Exchange, Navy Exchange, what have you.

Mr. BAKER. That is exactly my point. That is not charitable. It competes with you directly. It is a Government-subsidized operation. They are taking business from the free market, where there is no demonstration of need in the free market, that is not meeting the installation's need.

So, by having more merchants move from free market over to the military installation, you could open up a shopping center and have laundries, grocery stores, video rentals, every service they need, they would never lose the post. What does that do with the local community? In an age where you are having base closure and downsizing, that is devastating.

In my view, it has nothing to do with whether the proceeds are charitable. It has to do with whether the community needs are met by the free market, and they are not.

Chairman BILBRAY. One more question and then we will let Mrs. Clayton ask questions.

Mr. BAKER. I am done. I am sorry.

Chairman BILBRAY. You wanted to say something?

Mr. MCCARTHY. What I wanted to say is, doesn't our Government have an interest in stabilizing and strengthening the private sector? Because if it doesn't, then you are going to totally depress the tax base in the long run and you are going to have more and more cost shifting to the public sector. I think what we are all saying here is that the tax policy is eroding the strength of the private sector, which, in the long run, erodes the tax base.

Mr. BAKER. I am not disagreeing at all, I am trying to get to a basis on which we decide whether it is good—warranted—I won't say good. Whether the action is warranted, to have a nonprofit charitable military installation, a Governmentally supported entity providing a service that is acceptable. When it is not, and I am suggesting that it is broader than just a charitable question, which is the focus of the hearing today, that it is really a question of when does the Government provide an opportunity for competition to the free market system which is not warranted? And that is a broader view, and I am trying to help you.

I am just trying to make sure when we do it, we are not making things worse.

Chairman BILBRAY. Mrs. Clayton.

Mrs. CLAYTON. Perhaps that question would be for another hearing. Since we do have a question on nonprofit as unfair competition for profit, I guess I come at it in a different way. I guess the tax

law apparently was, as Mr. McCarthy said, is there has to be a public purpose for which a nonprofit should get a tax exemption, in the first instance, and that is based on the stated mission and objective, and that that public purpose is to serve some unmet need which is defined in that. That does not preclude, however, that nonprofit organization in going into activities that support that as long as indeed they continue their original mission.

For example, you mentioned the—I guess Mr. Santini mentions the colleges. The Catholic Church has done that for years. In some ways, they violate it. But by and large there has been the support for which the church has been doing.

I am struck by the analogy of the hospital and day care. As I remember originally, the public purpose of education was indeed public not private. I think that the private sector has responded to what they saw was a need, a need that was originally public, but there was a need that could be provided perhaps competitively and also very competently by the private sector. That does not preclude, in my judgment, that day care shouldn't be done by nonprofit.

Originally schools and after-school programs are not even thought to be profitable. I personally come from a very rural area where it is not even profitable to build housing for developers, but when maybe Farmers Home will allow those same developers who build in more suburban areas to build under a subsidy, they come. So, usually these public services that are now privately—the hospital obviously has gone into some related area.

You talk about home care. I remember we couldn't get a private sector to even go into home care. It came. It became profitable in the last 10 or 15 years in many areas in North Carolina.

Now, I work with a number of private organizations who provide home care. They do excellent, excellent work. But that is not to negate the value of having the public health of the hospital having home care.

I guess my point to any or all of you is there has to be some accommodation and some room for opportunity for both the public entities and the private sector to work. Indeed, we need to strengthen the private sector, because that is what our democracy and our form of Government is based on, is having the entrepreneurs and private sector to generate those resources. But there has been a purpose for nonprofits and there has to be a resource for that.

I didn't hear all of your testimony, I haven't had a chance to review it. But I did review testimony on the day care and the hospital, so I gather I would like either of you to speak to that particular, particularly as to public education and health care.

Mr. DOHERTY. Mrs. Clayton, you refer to the mission of hospital and home care and the availability of it and the availability varies depending on whether you are dealing with a rural or an urban situation.

The entire home health care industry was created by the private sector, not the public sector. It was in the——

Mrs. CLAYTON. I beg your pardon?

Mr. DOHERTY. Home care industry, as it exists both in the provision of home health service and agencies and home medical equipment service——

Mrs. CLAYTON. The home health care industry was created by whom?

Mr. DOHERTY. The industry as it exists was created in the private sector by free enterprise.

Mrs. CLAYTON. It didn't start that way in North Carolina.

Mr. DOHERTY. It does vary on whether it is rural or urban, but as a rule, nationally in the home medical equipment business.

Mrs. CLAYTON. That's a good point, it does vary whether it is rural or urban or whether it is affluent or nonaffluent. I guess it wasn't profitable to do it in nonaffluent areas.

My background is in health education, and some 15 years in home health. I started the first home health program. I had to beg to get it started in my county. They wouldn't start it in rural or disadvantaged communities.

Mr. DOHERTY. I think if you look at home medical equipment side of health care, which is where I come from, you are talking about nursing services.

Mrs. CLAYTON. Yes.

Mr. DOHERTY. But the medical equipment part is pretty much entirely, up to this point, the private sector. Even in your area, which is rural, I am sure that we have private enterprises operating, providing these services.

The problem we have now is that the industry has matured. It has gotten to a point where it is fairly sophisticated. Hospitals have a captive referral over patients when they come in for the treatment of an acute medical episode which is when the need for home medical equipment is recognized. They have total control over the disposition of that patient. The private company that has been out there for years servicing the community, and, in most cases, I am sure doing a very good job, is cut out of the loop.

The hospital doesn't have any of the overhead that the private company has. They can operate much more efficiently and, in most cases, they are billing Government entities where they are not cutting the costs.

We deal with national fee schedules. They are just making more money and providing less service, and the loser is the beneficiary, whether it be Medicaid or Medicare.

Mrs. CLAYTON. I misspoke. Home health as I know it was providing physical, physicians, or nurse practitioners, or therapists, and you are in the equipment business.

Mr. DOHERTY. That is correct.

Mrs. CLAYTON. Let me ask you, why wouldn't the 1993 tax reform, where they are preventing doctors from referring patients to where they have an interest in it, why doesn't that help protect you as a profit entity for having self-referral, from a hospital to an instrument?

Mr. DOHERTY. In my opinion, the arguments that were used to preclude physicians from self-referral situations, are the very same arguments that apply to the Medicare, Medicaid, or hospital side of health care. It simply wasn't included. I hope to see it included in the future. I think it is very much analogous.

Mrs. CLAYTON. You mentioned and talked about the day care. I, for one, hope there is an explosion of day care, because the work force in America needs day care. If there was—that is part of mak-

ing this economy competitive, is for parents to have affordable day care. You understand, if it is nonprofit, why the profit entity can't thrive and be competitive in them.

Mr. FOSKEY. Mrs. Clayton, we are not in disagreement. I have been in this business almost 20 years, long before it was trendy. Our concern is much like what has been discussed with the military installations.

We see bases building child care centers for employees on the base, and the bases downsize and budgets are reduced, they start reaching out to the community at large to bring in students, competing with me directly. In the case of after-school programs, Cobb County, Georgia, is the largest after-school program in the State of Georgia, caring for about 4,000 children and boasting of a quarter of a million a year profit. It did not focus their program until 2 years ago on children at risk at all. They were aimed at the affluent of Cobb County.

When they started receiving block grant funds through the Federal program, then through emphasis from the community leaders there was some scholarships then given to at-risk students. Our concern is that after-school programs are being developed in the affluent areas competing with private enterprise without any concern for those who are truly at risk and have the greatest need, the ones you and I would have the greatest concern for.

In our company, we established three programs in Houston County, Georgia. Two are aimed at the middle-income level; one at the low-income level. We struggle the greatest with the one at the low-income level because of apathy and community support for the program.

We are not in disagreement at all that nonprofits can serve an area or should be serving an area where there is a need and the private sector is not meeting that need. But our concern is where public school systems who are not on a level playing field, they have no regulation, no minimum health and safety standards, they operate above and free of those totally, where they can go out and compete with private enterprise that must meet those standards—and indeed we want to meet them. We feel all children, regardless of where they receive the care should be under the same health standards.

Mrs. CLAYTON. Thank you.

Mr. WEINBERGER. Mrs. Clayton, I just want to make a comment.

I agree with what your premise is. I think to synthesize it with what Mr. Baker said, and coming from the computer industry, which is not the health care industry, which might be not as familiar with, but it is the same issue. The issue is when you have a robust industry that is providing the goods and services like the computer industry, and it is one of our leading GNP—or whatever the term is, it is not GNP anymore, it is Gross Domestic Product, GDP—providing a lot of the growth. We are growing 20 to 30 percent of the year.

I, myself, happen to be chairman of the advisory board of the Moscow Business University, Moscow, Russia. We have Squibb, Heinz, U.S. West, and other companies on this board trying to change their economy. Everything we are doing around the world is to show that the private sector is the way to go. The reason the

United States is so strong today is that is what we believe in, we don't believe in Government when the private sector is doing the job.

Now we are talking about basically letting the Government compete equally with the private sector, which everybody knows is unequal, because you are getting all the subsidies you are talking about. So, I think what Mr. Baker was saying is really correct, if we have a robust area where the private sector is providing it, why give a competitive advantage to the nonprofits.

Chairman BILBRAY. Thank you.

We will have to end this and go to the next panel.

But I would like to thank all of you for coming, and I would like to pursue, Mr. Santini, the idea of this panel or this group to work together, and my staff will be contacting you on that.

Thank you all for taking your time to come here.

We will take just a 1 minute break while the next panel gets here, and, hopefully, they will come right up right away and we will get started.

[Recess.]

Chairman BILBRAY. If the next panel could proceed up here, we would appreciate it, so we could start their testimony.

We will restart the hearing at this time and we will start with Mr. Kemp.

If you will identify your organization, and we thank you for coming here.

TESTIMONY OF JOHN KEMP, EXECUTIVE DIRECTOR, UNITED CEREBRAL PALSY ASSOCIATION AND BOARD MEMBER, INDEPENDENT SECTOR, ACCOMPANIED BY JANNE G. GALLAGHER, GENERAL COUNSEL, INDEPENDENT SECTOR

Mr. KEMP. Thank you, Mr. Chairman, for the opportunity to present testimony on the behalf of the Independent Sector and its members from the Small Business Subcommittee on Procurement Taxation and Tourism, on the subject of unfair competition from nonprofits.

My name is John Kemp. I am executive director of the United Cerebral Palsy Association, a board member of Independent Sector. With me is Janne Gallagher, general counsel of Independent Sector.

Independent Sector is a national coalition of over 800 voluntary organizations, foundations and corporate-giving programs with national interest and impact in philanthropy, voluntary action, and other activity related to the educational, scientific, health, welfare, cultural, and religious life of the Nation. Based in Washington, DC, the organization was founded in 1980.

We will provide a list of all members to the subcommittee.

In 1989 alone, charities spent an estimated $389 billion in providing vast and varied human services. That same year, nearly 100 million people volunteered their services from Meals on Wheels to serving in homeless shelters to advocating for civil rights.

In recent years, some representatives of the business community and the Small Business Administration have charged that nonprofit organizations have an unfair competitive advantage over for-profit businesses because of our tax-exempt status.

I would like to raise just several points on this issue with you: First, both for-profit and nonprofit organizations serve the public good but in different ways. The exclusive purpose of nonprofit organization is to promote the public good.

The purpose is fulfilled through activities: Through education; conducting or promoting cultural, religious, or scientific activities; providing those in need with food, clothing or shelter; fostering self help; and advocating changes in public policy.

For-profit businesses are, of course, the underpinning of our national economy, providing the jobs and the tax revenue which make the American economy function.

For-profit businesses which provide social services may serve the public good, but their principal purpose is to make a profit. This distinction is recognized by the U.S. Treasury.

Second, nonprofit organizations do not have the profits in the same sense that private businesses do. All private businesses, however public-spirited, are run to produce a profit for their owners. By contrast, if a nonprofit has an excess of revenue over expenses, and we try to, the surplus must be used for the charitable purposes of the organization.

Third, the ability of nonprofits to receive tax-deductible contributions provides important public benefits.

Nonprofit organizations receive considerable benefit from charitable organizations—charitable contributions of money and volunteer time. This enables them to provide free or reduced-cost services to those with modest incomes.

Fourth, nonprofit organizations which engage in business activities must pay Federal income taxes on those activities. Nonprofit organizations must pay Federal income taxes at regular corporate rates on all income-producing activities which do not contribute to the accomplishment of their exempt purpose.

Fifth, a large body of law exists on the subject of whether income earned by nonprofits is subject to Federal income tax. Over the years, court decisions, IRS rulings, and determinations in individual cases have developed a very large body of law establishing which activities of nonprofits are sufficiently related to the charitable purposes of the organization to be tax exempt and which activities are subject to tax.

Sixth, it is not true that there has been a major trend of nonprofit organizations to enter into on a tax-exempt basis, areas traditionally carried out by for-profit businesses.

In fact, the reverse is true. In many areas pioneered by nonprofits, such as exercise facilities, health care, homes for the aged, and a wide variety of social services, for-profits have begun competing extensively to provide services traditionally provided by nonprofit organizations.

Seventh, very little of the annual sources of funds of nonprofits is from business activities. A myth being repeated is that there are $389 billion in taxable income in the nonprofit sector. This is not true.

Most of that $389 billion comes from tuition payments to colleges and payments from health care or from contributions and grants.

Eighth, nonprofit organizations make vitally needed social services available to those unable to pay for them. Nonprofits provide

a single system of care of all income groups, especially those who are geographically isolated, who are subject to discrimination, and who are expensive to serve.

Ninth, nonprofit organizations are responsive to their communities. The prime concern of a nonprofit organization is to fill an unmet need in a particular community it serves. We are typically organized by groups of individuals broadly representative of the community who serve as volunteers on the boards of directors an on committees.

Often, the volunteer heads of these organizations are neighbors or are otherwise known to the people being served and therefore provide an additional means of accountability.

Tenth, revenues received by nonprofits increase the accessibility of services to low-income individuals.

Eleventh, nonprofits are accountable to the public.

Twelvth, the integrity and accountability of nonprofit organizations is guaranteed in other ways as well. In addition to scrutiny by the IRS and State regulations, many major nonprofit organizations are accredited by either the National Charities Information Bureau or the Philanthropic Advisory Service of the Better Business Bureau, both of which are highly respected organizations.

Our opponent's basic position is that tax-exempt entities should loose their tax-exempt status when they provide products and services which are also available from for-profit businesses. The effect of this recommendation would be to require nonprofits either to withdraw from providing many service, or to pay taxes on revenues derived from providing certain services such as schools and hospitals, youth and adult recreation centers, nursing home, and scientific research and testing, which are also provided by for-profit businesses.

In addition, nonprofits would no longer be able to receive tax-deductible contributions which benefit many of these activities, and donors, by the way, would lose a significant incentive to contribute.

In conclusion, the fairness question raised by some representatives of the small business community ultimately is the question of fairness to individuals served by nonprofit organizations. From the foregoing, it is clear that nonprofits serve those individuals, their community,, their Nation, and the public good in a very special way that warrants tax exemptions and other Government policies which encourage the formation and strengthening of nonprofit institutions.

Thank you.

Chairman BILBRAY. Thank you, Mr. Kemp.

[Mr. Kemp's statement may be found in the appendix.]

Chairman BILBRAY. Mr. Graves.

By the way, your entire statement will be put into the record, if there is no objection, and you may summarize or however style you want to deliver your statement.

TESTIMONY OF MICHAEL GRAVES, PRESIDENT, YMCA, DELAWARE

Mr. GRAVES. Thank you.

I am Michael Graves. I am the president of the YMCA of Delaware, and I do have a longer statement than I will present.

YMCA's are not private health clubs. Youth programs are central to our historic mission of building healthy bodies, minds and spirits for all in our community. YMCA's work with seniors, with individuals with disabilities, and collaborate with other community organizations, with local school systems to address community needs.

At the YMCA of Delaware, we provide transitional housing for men recently released from prison who have mental health problems or are recovering from substance abuse. We have conflict resolution and peer counseling programs operating in every school in the State. We offer a youth leadership program; a mentoring program to African-American teens; a home for church basketball leagues; a program for pregnant teens that bring mothers as well as fathers in; and many other programs that benefit the residents of Delaware.

Our commitment to serving children and families has lead us to respond quickly and energetically to the country's rapidly growing need for affordable high-quality child care. The YMCA of Delaware is the largest child care provider in the State, just as YMCA's collectively are the largest nonprofit provider of child care in the country.

Our financial assistance policies make the YMCA child care programs a common ground, where children of all economic levels can receive the same quality care in the same setting.

YMCA's have been offering health and wellness programs for over 100 years. Today, YMCA wellness programs, from exercise classes through stress management and substance abuse prevention, have helped participants clarify their values and lead healthier lives.

With 10 percent of our population exercising three or four times a week at the vigorous level necessary to improve their health, affordable YMCA wellness programs help meet a real community need.

YMCA's meet all applicable standards for tax exemption. YMCA's have never failed the Internal Revenue Service's unrelated business income test for fitness programs.

Three recent decisions from appeals courts in three different States, Oregon, California, and Iowa, affirm that YMCA's also continue to meet stringent State standards for property tax exemption. YMCA's contribute many important services to their communities.

YMCA's also contribute importantly to building a sense of community in the areas they serve. They stimulate their members and others to give generously to meet community needs. They offer a choice to individuals and families seeking programs and services that reflect and perpetuate their values.

These are among the reasons why communities, including many small business owners and their employees support the YMCA.

I might add from my prepared remarks, that of our three newest capital expansions in Delaware, our newest branch is right across the street from a public housing project in Sussex County. We are working hard on an inner-city branch that is dead center in a community that is currently applying as a Federal Empowerment Zone. We are reaching out into a community that does not have libraries and churches and YMCA's, and we are hearing from a community-

needs assessment in all these areas that a YMCA is what helps create a community.

Thank you.

Chairman BILBRAY. Thank you.

[Mr. Graves' statement may be found in the appendix.]

Chairman BILBRAY. Mr. Lainhoff.

TESTIMONY OF TOM LAINHOFF, GUNSTON HALL

Mr. LAINHOFF. Thank you, Mr. Chairman, members of the subcommittee.

My name is Tom Lainhoff. I am the director of Gunston Hall in Fairfax County, Virginia, the home of Colonel George Mason, the father of the Bill of Rights.

I am speaking today on behalf of the American Association of Museums, which represents the 8,000 museums of every type, including 1,100 corporate members, most of which are small businesses.

The mission of Gunston Hall is to preserve, interpret, and promote this 18th century historic site in order to educate the public about the international significance of its owner, George Mason, for his unique contribution to the universal cause of human rights.

Educational opportunities that we offer include: Tours, a library, archives, lectures, exhibits, and special events. Our educational outreach includes: School programs and publications, on-line library services, none of which compete with small business.

When George Mason wrote in the Virginia Declaration of Rights, "that all men are by nature equally free and independent and have certain inherent rights" namely, "the enjoyment of life and liberty, with the means of acquiring and possessing property," he was placing the right to earn a living on a par with the other "unalienable rights" that his close friend, Thomas Jefferson, would enumerate 6 weeks later in the Declaration of Independence.

Just as the Virginia Declaration of Rights establishes the intellectual framework for the U.S. Bill of Rights, so, too, might this phrase, "with the means of acquiring and possessing property" be seen as the basis of a Bill of Rights for small businesses.

Gunston Hall Plantation is a public/private partnership. Although we are an agency of the Commonwealth of Virginia, only about 50 percent of our annual operating budget comes from tax revenue.

The remainder of our funding comes from earned income, gifts, grants and investments. State funding covers only our basic operational expenses. It is the supplemental income that enables us to accomplish our mission to educate the public about this important Virginian. That income subsidizes admission fees and activities making us accessible to all who want to come.

If the trends experienced by museums in the last few decades are any indication, these nongovernmental resources will become increasingly more important in the years to come. The key to our success in acquiring non-State funding in support of operation are two 501(c)(3) corporations which operate our museum shop, our membership organization and our endowment.

Our relationship with small businesses is based on cooperation not on competition. Of the nearly 300 vendors we use on a regular

basis, most are small businesses. Some, in fact, are in business specifically to supply the museum community.

Specialists in exhibit design and fabrication, conservation and building restoration, to name but a few, are among those with whom we do business on a regular basis and all are small businessmen. Multiply our situation by more than 8,000 times and you begin to get some indication of our impact on the market.

To accomplish our mission, we must attract visitors. Our interest in stimulating travel and tourism is easily understood. Our visitation is currently expanding at a rate of about 10 percent a year. Our success has had and will continue to have a ripple effect on other businesses throughout the region.

The business that we bring to hotels, restaurants and others multiplies our economic impact far beyond the actual dollar amount of our gate receipts or shop sales. When we stage special events, small businesses supply the printed materials, banners, foods and beverages.

The economic impact of the nonprofit arts, including museums of all types, has recently been documented by the National Assembly of Local Art Agencies. Their striking study, which we would like entered into the record, demonstrates that we generate $36.8 billion on an annual basis for the national economy, and support 1.3 million jobs.

For example, in Pittsburgh, we provide 9,386 jobs; in Reno, 842 jobs; and in an Ann Arbor, 437 jobs. Cultural organizations not only have a direct impact on the economy but on the entire business fabric.

At Gunston Hall our museum shop does not compete with for-profit gift shops. But rather is an extension of our educational mission. It is not a destination for customers but a service for our visitors. Proceeds are invested directly back into the operation of the museum, again to subsidize admissions and programs for all.

Our museum shop manager works closely with the members of our curatorial staff to help ensure that new merchandise is directly related to the mission of our institution.

Most of our merchandise is produced and supplied by small businesses. No member of the small business community has ever complained about unfair competition from our museum shop.

At Gunston Hall Plantation, we realize that we are contributing to the quality of life of in our region, that we help to make our community not only a better place to visit but a better place in which to live. A better place both for the small businesses, their employees and their customers, just as George Mason and the other founding fathers would have wished.

Thank you very much for the opportunity to testify.

[Mr. Lainhoff's statement may be found in the appendix.]

Chairman BILBRAY. We will hear Mr. Roschwalb's testimony, and then we have a vote on the previous question followed by a vote on the rule. Hopefully, Members will be able to come back to ask some questions. But I will definitely come back. We won't leave you here.

Mr. Roschwalb.

TESTIMONY OF JEROLD ROSCHWALB, NATIONAL ASSOCIATION OF STATE UNIVERSITIES AND LAND GRANT COLLEGES

Mr. ROSCHWALB. Mr. Chairman, members of the subcommittee. I am pleased to be here today and be the last witness of the day. Because I come bearing good news. The good news could be summarized by the word "symbiosis," which is a long word for common sense.

The relationships between the universities that I represent, land grant colleges, State universities and the small business community is increasing. The association, as you know, is rooted in the Morrill Act, passed in the middle of the Civil War.

We have 176 members, an average in-State tuition of $2,685, still in that way maintaining our obligation to serve the students of the States. The only reason our schools are in business is to serve the people of the States who created them, and the people of the States are very careful to make sure that is the case.

Some of you have served on State legislatures and you know the careful reviews that are given to institutions. The institutions are created for a number of purposes: Teaching, research, but service as well.

Our Extension Program goes back almost to the origins of the universities. There is no one in this room who does not have some knowledge of Agriculture Extension, to the later developed General Extension, and today Industrial Extension.

You may have before you, I hope that it was distributed, a text just published recently that is called "The Competitive Edge," which talks about how our institutions—it is just examples, it is not complete. But it shows how institutions and how industry are working together.

It is not incidental that the most recent publication on the Cooperative Extension System is called, "Education in the Public Interest," our people are aware of that and they understand it.

With regard to service, it is worth noting that in the past year, 85 of our Industrial Extension Programs in the universities had 16,000 assistance relationships with small businesses and large businesses, as well as in the country. They dealt with one quarter of a million organizations in the United States.

I should note also that those organizations' employees, small business employees, that we often hear about small business creating new jobs, and indeed they do. A lot of those jobs go to the students that graduate from our institutions. It is a constant relationship that is pervasive.

Many of you are familiar with the SBIR program, and more recently the STTR program. We have been involved in those programs. Fortunately, the chairman of our board, Dr. Langenberg, now President of the University of Maryland, was at the National Science Foundation's as deputy when that program came into being, with good assistance from Dr. Langenberg.

My boss, the President of the Association, Peter Magrath, just came back from a trip a few weeks ago where he went to a project created by Milt Stewart, whom everybody knows in the entire United States as the "great god of small business."

I have a text that I would be happy to make available, the essence of which was Dr. Magrath saying "we make it together or we

don't make it." He spoke out in Utah which has had a history, a low history of development of small business and university cooperation. That is changing, thanks to a lot of people who are involved with that process.

There is another aspect to our participation with small business, and that is right smack in the middle of communities we live in. Last year, in your home State, according to figures I acquired recently, students spent more than $200 million and they spent them primarily buying books which are not from university-owned bookstores, that is a point I should note, it was referred to many times today.

I don't know what the total numbers are, but increasingly universities lease their bookstores to Barnes and Noble and other corporations. They get paid rent at most, and they are not in that business any longer.

Increasingly, also, our schools have gotten out of the travel business. A lot of those ads that indeed involve university people are run by for-profit commercial operations, with the university having some arrangement with them worked out one by one. This is an increasing element in our relationships with the small business community.

In fact, it has been noted, if anybody is thinking of opening up a small business, a university community is a good place to do it. Even during the Great Depression, those communities tended to be very stable economically and the relationship between the university and those small businesses was fine.

I mentioned the travel agencies and bookstores. We were deeply involved in the UBIT situation, the unrelated business income tax. It was interesting to note that despite a great deal of effort made at those times, nothing came out that would suggest more law was necessary. We certainly are in favor of enforcing the laws that are on the books, and we think that we will pass muster very well in almost all instances because of that.

A final point. Beyond the downtown relationships which makes our institutions very sensitive to what is going on within the community, our trustees are people who come from the business community. For the most part, they are appointed by the governor, most frequently with a legislature approving, and frequently in States like Michigan are elected.

These are people who would not put up with the universities getting involved in inappropriate relationships. So, we would say that our relationships with small business on all counts are fine and getting better, and they are doing so because we have to. It makes sense for both parties to have that kind of relationship.

Thank you sir.

[Mr. Roschwalb's statement may be found in the appendix.]

Chairman BILBRAY. Thank you.

I think we all better get over and vote and we will be back as soon as we can.

[Recess.]

Chairman BILBRAY. The meeting will come back to order.

I don't know my if my colleagues will all get back. It is lunchtime and we have run into it.

But you have heard some of the testimony, and let me first say that the kind of organizations that are here today are generally not the kind of organizations that we are concerned about.

One of the things I am concerned about is the fact that, as I mentioned, I recall somewhere in my opening statement, is that there are 1,110,165 nonprofits in the United States today. The IRS told us that 43,975 new nonprofits are filed last year. We think the list is going on at about the same level this year.

Some of the problems that we have is some of these nonprofits—like I mentioned, that is 1 for about every 200 people in the United States.

You heard the testimony as to the tour group in Philadelphia, they have a nonprofit status, to the knowledge of the people, and we don't know because we don't have them here to answer it themselves. They don't know of any charity that they really donate to or who they work with.

One of the problems we have is the fact that legitimate, solid charities like yourselves, that are doing a good job for the people, are probably being hurt in two ways. One is the fact that just like on everything, when you have in any organization or group, you have bad apples that are out there, and of course that ends up coming back on all of you.

Second is of course some of these organizations have donor bases, that people donate to those charities not knowing who they donate to and probably taking money away from legitimate groups.

So, in looking at that, the first question I have to you, do you believe it is too easy to become a nonprofit, under our present system of law?

Anybody who wants to take that question?

Mr. KEMP. I don't think it is too easy to become a nonprofit. I think the—when you talk about the growth in the number at 1.1 million businesses that are now nonprofit and the growth of 4,300 or so, we are really questioning whether the IRS has been able to go through and cull out those that do not exist really anymore, and whether they are really purging and removing those organizations that are in there.

I would ask that maybe the IRS would also look at something like that; are they really cleaning out their lists and their files?

Is that really the active group? Because we see lots of them come in the community, coming and a lot of them going.

Chairman BILBRAY. I intend to get the IRS here. We tried to get them here today as part of one of the panels, but on the short notice they could not make it. But we do plan to ask them to come before the committee and answer these questions because that is something we got to know.

We know that they are only auditing a small minority of their returns, and about half of the returns are not coming in at all. These nonprofits are not even filing returns, and these are ones that are mandated to file a return, not some of those that are exempt from even filing returns.

But that is one of the questions that we have out there.

Mr. Graves?

Mr. GRAVES. I would just add that when we file our 990, it is about a half an inch thick, so the section that you held up before

has lots and lots of attachments to it. Single audit regulations for all of our State and Federal grants produce an audit that is probably closer to an inch thick, so there is a great deal of documentation demonstrating the work that we do.

Chairman BILBRAY. Well, you heard the testimony in regard to the nonprofit hospital in Honolulu. What is your opinion as to the legitimacies of nonprofits reaching beyond the scope of their original programs, to reach out to earn additional revenue in competition with business?

Do you feel that is fair or do you think there is a proper guideline, at a certain point you step over the threshold of propriety in that regard?

Mr. GRAVES. I am not familiar with beyond what we heard today, but I can——

Chairman BILBRAY. The YMCA, I know what you do. My daughter is a college student in San Diego and I sent her money to join the YMCA, to do her health activities last year. I know you reach out to a special, unique group of people. When I was a kid, it was either CYO or the YMCA was the typical, where you went for your health-related activities.

Do you believe, though, that there is a threshold that at a certain point should a nonprofit be able to do any sort of business activity it wants to as long as those monies filter back to the charity, or do you think there is a threshold where you should not cross it?

Mr. GRAVES. I would agree with the law, that the activities should relate to the charitable purpose, and our unrelated business income tax be paid on other activities.

Chairman BILBRAY. But you heard the testimony. The question is not a question whether or not you should not pay the taxes on the unrelated activities; it is a question of when a hospital sets up large cleaners, cleaning activity, and a portion of that, maybe 20 percent is designated toward their own hospital. Now they have the additional revenue and they are probably reporting their return and paying taxes on that other 80 percent, but at the same time, the building they built was built is sitting on tax-free land.

In most cases, in most States you don't pay any property tax on that property. They would not be paying other—like you say, built with charitable money, and so forth. Should they cross that threshold?

That was kind the of implication I got from the first panel today; that there is a threshold where charities should not cross that. If it relates to their activities, if it is goodwill and they are out there—or Opportunity Village in my area, which helps for the mentally retarded, training them, and they bring people goods in and they redo those goods, bicycles and then resell them, and then train other mentally retarded young individuals or older mentally retarded to function in society. I don't think there is any question on that.

But, we had the same argument in the prison industry when is I was in the State legislature. Prisons trying to make money were producing goods.

In one case in Nevada, they were producing brooms and selling them at Safeway, A&P, Giants, and Smiths, and all the other places. The local industries screamed and said: You are producing

brooms at a third of the cost that it costs us to produce. You are driving us out of business. We cannot survive any longer.

The mattresses were being made at the men's prison in Phoenix, Arizona. Mattress manufacturers were screaming: You are in competition with me.

What I am saying is that what we are trying to determine in this committee is whatever a charity wants to do is fine as long as the money relates back to the charity and comes back to the charity, or is there a point because of the tax-exempt status of the charity where, as the panel said, where they can get lower financing; they get charitable gifts; they have property tax free on some of their properties, and can compete at a better level; or is there some line?

What I am trying to understand from this committee, is there a line where charities should stop?

Mr. ROSCHWALB. Let me say, Mr. Chairman, that having been involved in a number of pieces of legislation that were put together with the absolute goodwill and a lot of attention, when they got out into the field, the complications, the uniqueness, the differences at the local and State levels played havoc with the legislation, and amendments were necessary and they didn't work.

Why isn't something like this handled at the local and State levels, where people can understand the line a lot better? Where the line might be in one place in Nevada, very different in New York, because of the circumstances of the laundry business or whatever.

If you try to solve it here, you either have to write a 900-page bill or you have 900 pages of regulations, which is much worse, and you tend not to solve the problem.

These are local issues. The hospital is a local affair. The business is a local affair and the communities should be forced by the community itself to come to some kind of resolution based on fairness, decency, honesty. I think it tends to work much better under those circumstances.

Chairman BILBRAY. What about the situation with the laundry, though, where they build a laundry and they sold 20 percent to one hotel and sold another 20 percent to another hotel and virtually there is nothing the local community can do about that, and yet because of the nonprofit status that we have given to the hospital, they have—it doesn't seem to me that the gentleman is going to lose his business because he seems to have a thriving business. He just doesn't have it thriving as much as he would like it to be and where it was just a few years ago.

If fairness is what I am trying to look at. It may well be that what we are looking at here is trying to find out is there really too many nonprofits out there that really don't deserve the status of nonprofits?

I have a friend that, he is an assemblyman in our State, just on a whim decided to set up a nonprofit. He calls—I forgot what he calls it now—but he sets up little seminars on helping children, parents adjust with children and kind of a "tough love" type of situation, and it was very easy.

I mean, he filed his papers with the State of Nevada and 2 weeks later he got his thing back, and 3 months he got his tax-exempt status and afterwards he ran with it.

I am not saying it is not legitimate, because it is. But I know how easy it was for him to get it. I know a couple of people donated a couple of pieces of property that gave him a start, and he sold those properties and that gave him the start on this little foundation. They got the tax exemption for donating it to him.

I think that is what we are looking at basically, is this committee is hearing a cry out from the business community, and it is not just isolated. We are getting a lot of inquiries, a lot of calls saying: You are the Small Business Committee, you are supposed to be helping small business and yet the Government is interfering.

You heard that testimony. They are building a RV campground at Fort Belvoir, and I have one right down the street. The Fort Belvoir is all the retirees and ex-military and anybody else that can qualify for Fort Belvoir and can use their camp at half the price, because it is on Government land, and he doesn't pay any taxes. They hook up to the sewer and the Government takes care of the sewer bill.

That is what we are hearing. That is the reason for these hearings, is trying to find out what is going on out there; why are we hearing all this, help us, help us, help us.

On your side, and understandably, you don't feel there is a problem. But they feel there is a problem. We just felt in fairness we had to hear them. If I just decide there is a problem and there is something we can do—one of big things I am seeing is I think, personally, it is too easy to become a nonprofit, that you should show real justification for being a nonprofit. Just don't say I am forming a nonprofit, eleemosynary corporation to help put kids through school, and your charity may never do that.

You may never give one scholarship or not give any kids help to do it, but just take the money. Your organizations are well-known and outstanding, no one can question your groups. But there are some groups out there, when you have 1.1 million—and you may be right. There may be only 400,000, maybe the other 700,000 are dormant. But with only 500 people, if the IRS that are geared toward finding that out—that is way too few, and it may well be.

I was talking to Representative Clayton on the way over, and I said, well, maybe it would be good to get an authorization in to find out if we shouldn't get some more people in IRS that are able to audit those returns and find out if they exist. If people don't file returns, be able to find out why they don't file returns and are they no longer in existence, have some penalties for maybe not terminating your charity. Go back to the founders, the people who created the charity, at least have some responsibility to file a paper with the Federal Government, which we have now, but have to file a paper terminating the status and removing them from the rolls.

Mrs. Clayton, do you have some questions?

Mrs. CLAYTON. I think Mr. Graves had one.

Mr. GRAVES. I just wanted to comment quickly. There was earlier testimony about small businesses' contribution into the former Soviet Union. I was part of a delegation that in 1990 went to what was then Leningrad, to help reopen the YMCA's that were closed during the revolution. One of the things we were looking at privatizing into a nonprofit sector was the community centers that were attached to the collectives. Over and over in every community

we visited, they didn't understand community development and citizens organizing themselves to address community needs.

So, although we may have a need to address the ease at which we can create nonprofits in the United States, this was 4 years ago a whole country that didn't know how to solve problems for themselves, weren't allowed to organize, had no philanthropic history, including their churches.

The churches were funded by the Czar prior to the revolution and went underground after that. It was the single biggest impression that I came back from, was that they do not know how to organize themselves to solve local community problems.

We want to make sure we don't throw out the baby with the bathwater.

Chairman BILBRAY. That is understandable, and I don't think anybody wants to do that.

The last thing I want is any of you to feel that we are threatening your status as nonprofits, that we want to take away your ability to function as nonprofits.

We understand what you are doing and we approve it. We want to see how far and where there problem really goes.

Mrs. CLAYTON. I think on that line, part of the problem in addition to the lines you were saying, that you really are not trying to unstabilize the nonprofit or dismantle that.

There is also the perception, in addition to the small business community complaint, is that there are nonprofits who do you a disservice in the perception of being a nonprofit, when you are legitimate in providing the services. That this in itself gives the understanding that it is such an easy vehicle to do personal greed or gain or have no accountability to the donors or to be a forum to allow people to donate and make charitable contributions, when there is avoiding of taxes.

I don't know if any of you have recommendations that speak to the monitoring of it or speak to the self-policing that would give—you must have heard all of the stories of people raising an enormous amount of money in the name of charity, even churches for that matter, and nothing happens.

There is no way to make anything absolutely pure, but it seems to me that some recommendations coming from the nonprofits themselves would go a long ways in suggesting how to monitor them, the perception, because it is doing you a great disservice and pretty soon that translates into credible donors saying, well, here it goes again. Notwithstanding our IRS, if you don't have donors, you don't have to worry about IRS, because there is no reason for you to be in compliance.

I would like to hear if you have comments to make.

Ms. GALLAGHER. Could I respond?

Chairman BILBRAY. Would you identify yourself.

Ms. GALLAGHER. For the record Janne Gallagher, and I am acting as counsel to Independent Sector, too, for this hearing.

Independent Sector is deeply concerned about these problems as well. It is for that reason that it has been working very hard to craft a new set of enforcement tools for the Internal Revenue Service in the form of intermediate sanctions, which are a kind of excise tax that would be assessed against people who abuse charities ei-

ther by taking excessive compensation from the charity or by other kinds of insider dealing such as nonfair market rentals.

Independent Sector supports, though, law changes. If I heard the business coalition's testimony this morning, I think we are probably in agreement with their fourth set of recommendations.

We also support increased enforcement ability on the part of the Internal Revenue Service. So, I think that we all acknowledge that there are problems and that those problems do hurt legitimate charities.

Chairman BILBRAY. Could we get a copy of those recommendations that you sent?

Ms. GALLAGHER. I would be happy to supply them.

Mr. KEMP. May I also add that Independent Sector has just finished a task force report on accountability of the nonprofit sector. We would be happy to provide that report to you with the set of recommendations about accountability.

Chairman BILBRAY. Thank you, we would appreciate.

Mr. ROSCHWALB. Just a historical note, until 1982, the Department of Education sent from the regional offices people to check every university's operation of student aid. Mostly, they were fine. They needed some repair and the like. Then for a variety of reasons, all bad, they stopped that and then all you heard about was the results since then.

Now, it is going back in a monumental piece of legislation that involves all the States and probably would never have been necessary had there been that kind of check. Some people will just play for what they can, given the opportunity to do so. It is usually the very small minority, but they poison the well for everyone.

Mrs. CLAYTON. Thank you.

Thank you, Mr. Chairman.

Chairman BILBRAY. Thank you.

One other question, you heard the comments on the—like the student bookstores that were selling the computers at much lower price, and they were going out to nonstudents as well as students. I notice in your testimony you said that many of bookstores today are not nonprofits any longer, they are leased from the university and they pay sales tax and they pay corporate taxes like everybody else.

Mr. ROSCHWALB. They just have a business that happens to use—it is like if you go to many large campuses, the big land grant schools, you will find at small campus stores usually big national branches, Burger Kings, and so on. They rent the space and the kids have what they need and the university gets a rental and that is all.

Same thing is true of the bookstores. There is another thing in the bookstores that is interesting, and I don't have documented evidence, but I probably could get some, the problem with the computers was initiated by the manufacturers, not—this goes back some time—not the bookstores.

They provided a vast amount of equipment at low prices to students who would become friendly to that brand, it is not an unknown practice.

Chairman BILBRAY. Like American Express sent my daughter, who has no income, an American Express Card. I really appreciated that.

Mr. ROSCHWALB. Same idea, you get the students used to them and they made them available and students did, in fact, pick up—some students picked up more than one copy. This was the manufacturer provoking a problem.

Now, it is pretty much, at least in the association, I know, that is a business that does not belong to the university. There are exceptions, and I am aware of them. But by and large, they are getting rid of them because they can't afford to run them as well.

They have to depend on people to operate and report back to the president. It is much easier to lease it and make something on the lease and not have to worry about the management, and Barnes and Noble really know how to run those much better.

Chairman BILBRAY. I see.

Well, gentlemen, I appreciate you coming before us today and we will be working on this problem for a little while and in trying to see if we can't come up with something.

We do appreciate you giving us that information. We do plan to have the IRS down here as soon as we can subpoena the IRS or do something to get them here. It is kind of fun to call them in; of course, they can get even, too, I guess.

I do appreciate it, and I thank you all for your patience in wading through this.

The meeting is adjourned.

[Whereupon, at 12:43 p.m., the subcommittee was adjourned subject to the call of the chair.]

APPENDIX

Opening Statement of the
Honorable James H. Bilbray
Chairman
Subcommittee on Procurement, Taxation and Tourism
Committee on Small Business

June 16, 1994

Today, the Subcommittee continues its investigation of unfair competitive practices from government entities and government supported institutions. As a matter of background, this investigation began last year, as the Subcommittee focused on the particular concerns of the travel and tourism industry. The issues brought up by the small businesses that testified before us at that time, made it clear that there was a much broader range of concerns in a number of other industries that deserved further exploration. This is the point at which we are today.

The Subcommittee has sought to explore these expanded concerns by dividing our investigation into three hearings: government unfair competition, nonprofits and public utilities. I had hoped to begin with a discussion of the unfair activities that our own government has been involved in, however, due to schedule conflicts, that hearing has been shifted to June 28. Therefore, today we will begin with concerns regarding nonprofits.

The Subcommittee enters this discussion with an open mind and no pre-conceived notions. The Subcommittee acknowledges the great service and benefits that nonprofits provide our society. It is our intention to allow both the private sector and the public sector an opportunity to express their understanding of the issues and to try to clear the confusion and questions that surround the commercial activities of nonprofits. Our goal is to clear up the abuses that may be taking place and to insure the continued viability of and confidence in nonprofits. However, we must also keep in mind that this issue has been deemed important enough to not only be included as an issue for the upcoming White House Conference on Small Business and has gotten a great deal of attention from the Committee on Ways and Means.

As of 1993, there were 1,110,265 organizations exempt from taxation under section 501(c). In 1993, 527,847 of these organization filed information returns with the IRS. In that same year 43,975 new organizations were approved. Leading up to this period, IRS staffing with regards to examination and determination of tax exemption, has remained fairly constant at around 500 employees. These 500 employees are responsible for not only new applicants but also managing investigations with regards to existing nonprofits.

This Subcommittee concurs with the Oversight Subcommittee of the Committee on Ways and Means, that there is a need for stronger oversight by the IRS over the activities of nonprofit organizations. The staffing and funding levels allocated to the IRS should be commensurate to the number, size and diverse activities of tax-exempt organizations. This improvement should also include a review and upgrading of reporting requirements along with stricter reporting requirements from nonprofits.

However, we must also keep in mind a number of questions that have arisen with regards to the Unrelated Business Income Tax (UBIT). The explosion of nonprofits, as signified by the figures that were stated earlier, have no doubt strained the traditional donor bases of many nonprofits. It is natural in this atmosphere for these organizations to seek new sources of income, particularly through commercial activities. While each activity is unique in its own, this entry into commercial activities has placed nonprofits in direct competition with small businesses in a variety of industries. In addition, the advantage that nonprofits hold due to their tax exempt status has given them a clear financial advantage.

In a 1987 report to the Joint Committee on Taxation, the General Accounting Office reported not only how the disproportionate IRS staffing affected their investigative capacity but how it was compounded due to the difficulty of administering the UBIT. Congresses' intent with the UBIT was to prevent unfair competition between taxable businesses and nonprofits with respect to commercial activities unrelated to the exempt purpose. The IRS stated at that time that this criterion is difficult because there are no concrete rules to determine the relation between commercial activities and tax-exempt purpose. In addition, a number of questions were raised about the large number of exemption categories. Because of the questions that were raised by this report, and because most of them still remain, I have written to Comptroller General Bowsher and asked him to provide this Subcommittee with an update of that report.

This is a concern brought to us by small businesses and affecting small businesses. If small businesses are to maintain their viability in the commercial environment, we must not throw any more roadblocks in their path or make the playing field uneven. Whatever confusion may be resulting due to IRS inadequacies or problems with the UBIT rules should be rectified in order to allow a level playing field that will promote small business opportunities and foster nonprofit charitable purposes. To this end we have asked two panels of witnesses to come before us today.

Representing the private sector we will have: the Business Coalition for Fair Competition; the Textile Rental Services Association; the Computing Technology Industry Association; the Association of Quality Clubs; the National Child Care Association; and the National Association for Medical Equipment Services.

For the nonprofits we will receive testimony from the YMCA; the American Association of Museums; the Independent Sector; the National Association for the Blind; and the Association of American Universities.

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Testimony of David Applebaum
Before the Small Business Subcommittee
on Procurement, Taxation and Tourism
June 16, 1994

My name is David Applebaum. I am President of Young Laundry & Dry Cleaning, located in Honolulu, Hawaii. I am testifying on behalf of the Textile Rental Service Association of America (TRSA) which represents over 1,100 member companies. The textile rental industry is made up of for-profit companies that provide textile maintenance service to commercial, institutional and industrial accounts. Our companies rent and service hygienically clean textile items to virtually every type of business in America with major emphasis on the health care industry, hotels and restaurants.

I commend the subcommittee on holding these important hearings and am appreciative of the opportunity to testify. It is critical to not only my own industry, but to all taxpayers who have been damaged as I have that Congress be made aware of the serious damage that nonprofits are not only doing to private businesses in the textile rental and other industries, but also seriously eroding the tax base from which Congress extracts taxes to pay for the cost of our government. And gentlemen, as we sit here, the problem is steadily getting worse.

I will focus on what has happened to me, the damage that I've suffered because of the nonprofit hospital industry. Bear in mind that this little episode way out in paradise is being repeated countless times throughout the entire country, not only in the laundry and linen rental industries, but in scores of others as well. I will follow with my commentary and recommendations.

In 1984, Young Laundry & Dry Cleaning was the largest provider of laundry services to hospitals in the state. In 1985, Kuakini Medical Center, a hospital of 250 beds, took the Convalescent Center of Honolulu from me. This account ran $10,000 a month and Kuakini's price was 40% below ours. In 1986, Queen's Medical Center, a 503 bed teaching hospital, took Kaiser Hospital from me. Kaiser ran $35,000 a month in sales and price again was over 40% below ours.

These price differentials are astounding considering our pre-tax earnings were running under 5%.

At that time, I went to both hospitals and complained that they were selling their service way below their costs, aside from whether they had any right to compete with me in the first place. Both assured me that according to their own cost schedules they were not selling below their cost.

It was at that time I learned that the not-for-profit hospitals were under no obligation to use generally accepted accounting principles when calculating their costs. And it was at that time that I became fully aware of the absolutely mindboggling advantages that the hospitals have - they are very much a government subsidized competitor.

- They have access to cheap money via bond issues.
- They pay no income or property taxes.
- They are allowed unlimited entry into unrelated business ventures as long as they pay taxes on their income from these ventures - as we shall see later this is a big farce.
- They are no longer obligated to provide unlimited charity care - they can and do turn patients away when it suits them.
- They get paid for over 90% of the services they provide from insurance companies, Medicare/Medicaid, Social Security and private taxpayers - all at a level that affords them a profit over their cost of doing business.
- The average charity care nationwide for nonprofit hospitals is 6% of expenditures.
- They are not obligated to include the fair market value of assets employed in providing service. Thus, donated land, buildings or equipment is not included as a cost when setting their prices.

I was so perturbed at the time, that I threatened a law suit against Queens Medical Center. In order to head this off, Queen's promised that they would prove to me that they were indeed selling above their cost. What followed was approximately one year of exchanging information, most of it wrong, and when the wrong information was challenged it was replaced by additional wrong information, delay after delay, haggling over minute details, shifting me from one person to another (thus a couple of times having to start the process over) until a year had past and tens of thousands of dollars had been paid to my legal advisors. I gave up - my pockets weren't deep enough to continue the fight - they won.

In 1991, Queen's Medical Center built an off-site laundry facility that contained excess capacity over their own requirements. The laundry was built on donated land and the building and equipment was financed through tax-exempt bond issues. QMC has stated that they did not use the bond proceeds for the portion of the building that related to the laundry. Big deal - they paid for it with cash from operations which is as much a charitable asset as bond proceeds and should carry the same restrictions. From the date the laundry was completed, QMC went full blast into the commercial field and took many other hospitals, nursing homes, laboratories and other healthcare facilities from me. And they continued their deep discount pricing mode, even though they were in a brand new multi-million dollar building, located in a very expensive industrial park and outfitted with the most modern state-of-the-art, very expensive laundry equipment. My company is one of the more productive companies in our industry and if we performed the same services for the same cost as Queen's is charging, we would not have enough to cover our cash cost of providing these services, let alone anything left for overhead.

In 1988, a consortium of four entities - Kuakini Medical Center, St. Francis Medical Center and Kapiolani Medical Center for Women and Children plus a private individual formed and funded a corporation for the purpose of providing laundry services for themselves. They bought land, erected a building and installed very expensive state-of-the-art laundry equipment. The capacity of the plant thus built was far in excess of the needs of the three hospitals. The name of this company is United Laundry Service - and they promptly proceeded to take the rest of my health care business, again at cut-rate prices.

Then, in 1991, United Laundry Service sold a fifth of itself to a hotel chain in exchange for the hotel chain's business - thus causing me yet another huge loss.

Then, in 1992, they sold a sixth of themselves to a second hotel chain - thus causing me yet another huge loss.

I have a deep seated conviction that some private benefit and/or private inurement took place in these transactions. I have tried to find out, unsuccessfully, what the deal was when they took in additional shareholders. How were the assets valued at the time new shareholders were brought in, and what did the new shareholders pay? I could not find out this information and I don't have enough funds to pursue it in the courts.

The bottom line is that these two plants, funded owned and operated by not-for-profit hospitals, have taken $10 million dollars in annual sales from Young Laundry and Dry Cleaning. This represents 40% for our business.

> Let's look at how this has affected me. I have purchased capital at prevailing rates to buy land, building and equipment sufficiently capable of handling $25 million dollars of annual sales. I further have recruited and hired competent staff who in turn have trained and manage a competent workforce - all designed to be able to turn out the necessary product at very productive rates for a $25 million dollar year business. And all the while this was being done, we made money and paid taxes. Not only did we do it all on our own, without help from anyone, we were constantly exposed to financial ruin if we failed. I had to guarantee all of my personal assets including first born children in order to obtain funds. Then, along comes a charitable organization that - abiding by rules and regulations that you have approved - possessing tremendous advantages - invades my business. They take not only healthcare linen rental business that they themselves use, but go into hotel and restaurant business which is entirely unrelated to their mission.

Ladies and gentlemen, you are looking at a very unhappy camper.

> Let me tell you what else has happened. $10 million dollars a year of business (and the assets necessary to produce those sales) have moved from the tax-paying sector of our economy to the non-paying sector. The tax

> base has been eroded, permanently, by the profits that $10 million dollars a year was earning. And don't be fooled by the law that requires for-profit entities of nonprofit organizations to pay taxes on their income. As you will see in my commentary - it doesn't work that way.
>
> So here I sit with a very perplexed view of my government. On one hand, you see additional needs of our citizens that have to be met, and combined with existing programs results in an ever increasing cost of government. On the other hand, you have a situation wherein you allow a significant sector of our economy to behave in such a manner that damages private for-profit enterprises, and thus diminishes the tax base from which you extract funds to pay for the cost of government.
>
> The logic of your actions and arithmetic escape me.

Hospitals were granted tax exempt status in the early part of this century when the government decided that the charity healthcare problems of society could best be handled by hospitals and gave them their tax-exempt status in exchange for the promise not to render the necessary charity healthcare but also run their operations on a nonprofit basis. Today, there is little resemblance to that scenario. Nationally, hospital charity costs are approximately 6% of their total expenditures and would probably be less than that if they quit their costly TV commercials.

Today, over 90% of the hospitals services are charged at a profit - to insurance companies, Social Security, Medicare/Medicaid, and the private taxpayers.

Nonprofit hospitals make money - and some of them make a lot of money. However, most of it doesn't show because they have distributed their excess cash to foundations and other investment companies that run their for-profit activities. The annual reports of the hospitals in most cases do not reflect the wealth contained in their foundations and other holdings.

The hospitals pay no income taxes or property taxes on their own earnings. Supposedly, they pay tax on the profits of their unrelated business activities - but this is a giant farce. They control the profits by adjusting the charges between them, and additionally a good part of the for-profit activities run at a loss. And in

this case, where the for-profit entities run at a loss - how do you think we poor taxpayers feel? We've been taxed to provide the hospital with charitable assets - which are then used to fund a money losing activity - thus forcing us to be taxed again to fund the losses!!

And in those instances where the unrelated business does make money, and does pay taxes, I call to you attention the schedule I've attached showing the true impact of these funds. Remember, the key is not the taxes that are paid by the for-profit activity of a nonprofit hospital, but rather the after tax cash that's left over.

That after tax cash in the hands of a taxpayer like myself continues to earn money and pay taxes. Once that after tax cash goes to the nonprofit, it's lost forever and no more taxes are forthcoming.

A nonprofit hospital receives money in the following ways:

- They sell bond issues and pay no taxes on the bond proceeds. Further, if you buy these bonds, the interest from them is tax free, and therefore the interest they must pay in order to entice you to purchase is quite low.

- Receipts for services rendered come from various sources (Medicare/Medicaid, Social Security, disability payments, insurance companies and taxpayers) and are not taxed, but the cost of providing those benefits (insurance) is deductible.

- Money received from contributions and fundraising activities are not taxable to the hospital, yet are deductible by the donor or contributor.

Having received money, or charitable assets, as just described - what is the giant leap in logic or thought process that allows the hospital to use these charitable assets to go into for-profit businesses that not only reduce the tax base, but severely damage private entrepreneurs like myself. The typical healthcare executive will answer this question by saying that the hospital needs the money from these for-profit activities to meet its expenses and hold down hospital costs. I think quite the contrary is true - that the hospital doesn't need these earnings and as a matter of fact these earnings serve only to increase their surplus cash.

> As a matter of fact, in the last 20 years, the cost of a hospital room has gone up 713% or three times the rate for inflation, and hospital revenues have gone up four times the rate of inflation. And, since 1950, hospital assets have gone from $19 billion to $195 billion after adjusting for inflation.

The area of bond issues is one of concern for potential abuse. Supposedly, tax-exempt bond issues are based on the promises and affidavits of bond counsel that all proceeds will be used for only tax-exempt purposes. This is an empty statement. The bond proceeds merely free up other charitable assets that are used for for-profit activities. I have read that the IRS has identified approximately 25 tax-exempt bond issues for scrutiny for possible violations and has approximately another 100 on the waiting list. This is more than likely a drop in the bucket. The IRS freely admits that they are woefully understaffed in this area.

To my knowledge, neither of the hospital-owned laundry plants in Honolulu used the fair market value of their assets, especially land and building, when pricing their services. And, they were both built initially with substantial excess capacity.

According to David Hymnan, a Law Professor at the University of Maryland, the value of tax exemptions for hospitals are approximately $8 billion dollars per year, and according to data collected by the *Philadelphia Inquirer,* the total tax exemption value of all nonprofit activities including hospitals exceeds $35 billion per year.

The tax-exempt hospital no longer has to provide charity care., They can and do turn patients away without danger to their tax-exempt status. In 1969, the IRS changed the definition of charity from "ability to pay" to "community services" - the definition of which is so broad as to be open to almost anything. The reason for the change was the recognition by all parties that almost all patient services were being paid for, and at a profit.

And the most obscene part of this entire scenario is that it is not illegal - at least, not yet. And this leads me into my recommendations.

The schedule attached shows the effect of transferring $100 of annual income from a taxpayer to a for-profit investment of a nonprofit operation. The taxpayer pays taxes on his current earnings as well as investment income. The schedule shows that at the end of 10 years the taxpayer will have accumulated $838.33

while having paid $158.87 in taxes. Contrast the effect of the same scenario for the for-profit investment, which does pay taxes, of a nonprofit owner, which does not pay taxes. The same earnings result in an accumulation of $1051.88, or 25% more than the taxpayer in just 10 years, and of course no income taxes on the investment earnings.

To get some idea of the total impact on the economy of the above scenario, the hundred dollars a year, with its cash accumulation and taxes paid figures indicated, should be multiplied by the total income of all of the for-profit investments of nonprofit owners, and further it should be extended to a 20 and 30 year period which is how long this has been going on. The number has got to be horrendous - so much for the argument that the current system is fair become the for-profit business of nonprofit owners pay their fair share of taxes.

Recommendations

The granting of tax exempt status was intended to be in exchange for receiving charity services which the government would otherwise have to provide. It was not intended for the nonprofits to use the privileges thus granted to go into for-profit businesses.

The following remarks were made by Judge Robert Young, a Pennsylvania Judge, who ruled on several cases involving hospitals tax exempt status in Pennsylvania:

> "Act like a charity - if you don't we'll take your assets and pass them on to a group that will."
>
> "Provide care to the poor by finding and providing services for them where they are and not waiting for them to come into the front door."
>
> "Charge fair rates and curb advertising budgets."
>
> "Do not purchase physician practices and for-profit businesses."
>
> "Do not base executive pay on the bottom line."
>
> "Avoid accumulating big fund balances - it is not in the community's interest to have you sitting on hundreds of millions of dollars."
>
> "Act like a charity - stop focusing on your need to survive. Your importance carries not privileges, just responsibilities."

My first recommendation, admittedly self-serving, would be to prohibit nonprofit hospitals from entering into the commercial laundry and linen rental business. Nonprofit hospitals should be prohibited from serving non-healthcare customers from either their on-premise laundries or shared service laundries. Further, they should be prohibited from serving other healthcare customers from their own or shared facilities where there is adequate commercial services available.

I would also recommend that the restrictions as outlined in the above paragraph apply to nonprofit hospitals in all other commercial enterprises as well as the commercial laundry and linen rental business.

I also recommend that nonprofit hospitals be restricted as to the amount of investments they accumulate - including all spinoffs, foundations and separate organizations. Additionally, their income from all sources should be limited to 10% above their expenses for all activities. If income rises above the 10% limitation, the hospital would have to compensate by reducing room rates and/or the cost of surgical procedures to the point where their income was reduced to a level where it did not exceed 110% of expenses. Additionally, the existing controls on hospital operations now in place should be maintained and the IRS should be mandated to hire adequate people to ensure compliance.

Attachment

COMPARISON OF DOLLARS ACCUMULATED AND TAXES PAID
NORMAL TAXPAYER VS. UBI OF NON-PROFIT HOSPITAL

Normal Taxpayer

Year	Current Earnings	40% Tax	$ Available After Tax	Plus Balance	Total Available for Investment	Earnings on Investment	After Tax Earnings	New Balance
1	100.00	40.00	60.00	-0-	60.00	6.00	3.60	63.60
2	100.00	40.00	60.00	63.60	123.60	12.36	7.42	131.02
3	100.00	40.00	60.00	131.02	191.02	19.10	11.46	202.48
4	100.00	40.00	60.00	202.48	262.48	26.24	15.75	278.23
5	100.00	40.00	60.00	278.23	338.23	33.82	20.30	358.53
6	100.00	40.00	60.00	358.53	418.53	41.85	25.11	443.64
7	100.00	40.00	60.00	443.64	503.64	50.36	30.22	533.86
8	100.00	40.00	60.00	533.86	593.86	59.39	35.64	629.50
9	100.00	40.00	60.00	629.50	689.50	68.95	41.37	730.87
10	100.00	40.00	60.00	730.87	790.87	79.09	47.46	838.33
Total Investment Earnings for 10 years						$397.16		
Tax Rate						40%		
Taxes Paid						$158.87		
Total Investment Earnings for 30 years						$5380.06		$5028.06
Tax Rate						40%		
Taxes Paid						$2152.02		

UBI of Non-Profit Hospital

1	100.00	40.00	60.00	-0-	60.00	6.00	6.00	66.00
2	100.00	40.00	60.00	66.00	126.00	12.60	12.60	138.60
3	100.00	40.00	60.00	138.60	198.60	19.86	19.86	218.46
4	100.00	40.00	60.00	218.46	278.46	27.85	27.85	306.31
5	100.00	40.00	60.00	306.31	366.31	36.63	36.63	402.94
6	100.00	40.00	60.00	402.94	462.94	46.29	46.29	509.23
7	100.00	40.00	60.00	509.23	569.23	56.92	56.92	626.15
8	100.00	40.00	60.00	626.15	686.15	68.62	68.62	754.77
9	100.00	40.00	60.00	754.77	814.77	81.48	81.48	896.25
10	100.00	40.00	60.00	896.25	956.25	95.63	95.63	1051.88
Total Investment Earnings for 10 years						$451.88		
Tax Rate						-0-		
Taxes Paid						-0-		
Total Investment Earnings for 30 years						$9061.73		$10,856.73
Tax Rate						-0-		
Taxes Paid						-0-		

NAMES

National Association for
Medical Equipment Services

Testimony

of

Richard Doherty, President
Comprehensive Home Health Company

and

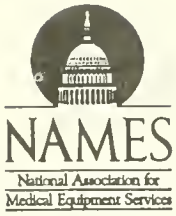
Representing
the
National Association for Medical Equipment Services

on

Unfair Competition

Hearing
of
Thursday, June 16, 1994

Before
the
House Small Business Subcommittee
on Procurement, Taxation and Tourism



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On behalf of the National Association for Medical Equipment Services (NAMES), I am pleased to have this opportunity to comment on the issue of unfair competitive business practices within the health care system. I am Richard Doherty, President of Comprehensive Home Health Company in Avon, Massachusetts and Immediate Past Chair of NAMES Board of Directors.

NAMES membership comprises over 2,000 home medical equipment (HME) companies which provide quality, cost-effective HME services and rehabilitation/assistive technology to consumers in the home. These companies take pride in providing personal, comprehensive

HME services in the setting where the vast majority of individuals prefer to recuperate — the home. HME consists of basic aids for daily living and a vast array of highly specialized and advanced services, such as infusion therapy for the provision of antibiotics and chemotherapy; oxygen and ventilator systems; wound care and ostomy supplies; and advanced rehabilitation equipment and assistive technology.

Specifically, the HME services industry is concerned about consumer choice of health care providers under national health care reform. We especially are troubled by the growing proliferation of non-profit hospitals' ownership of HME companies — a classic example of a "captive referral" scenario.

I. Choice of Provider Under Health Care Reform

NAMES maintains that all Americans should have the freedom to choose their health care providers. Under the Administration's Health Security Act, health plans theoretically could contract with just one provider in a given field to provide the appropriate care. Such a practice would limit the choices of available providers from among which consumers could select. Under such a practice, HME suppliers, from whom consumers already may have received prior care or whose companies are closer to home, could be closed out. Therefore, NAMES recommends that the final health care reform legislation should provide incentives for health plans to contract with as many providers as necessary to meet the needs of the community. At the very least, there should not be any disincentives in the system to allowing for full provider participation.

No matter what shape health care reform takes, we believe consumers and purchasers of health care should be permitted to exercise free choice based upon quality, cost and satisfaction. There can be no meaningful consumer choice, however, without market access by truly competing providers of care. NAMES already is beginning to see situations develop

where consumer choice is being severely limited primarily because some third party payors will contract only with one HME supplier. Our concern is that reducing the number of providers in a given field will result in **decreased competition**, eventually driving up prices while diminishing quality of care. No single provider can adequately cover as large a geographical and populated area as envisioned in the Health Security Act. HME companies vigorously oppose the concept of such a "competitive bidding" system for HME items that essentially would lead to diminution of services and quality.

HME suppliers strongly support the following "freedom of choice" principles:

- No provision in the final health care reform plan should be constructed to allow monopolization, attempted monopolization, conspiracy to monopolize or other restraint of trade prohibited under the existing antitrust laws;
- Any proposed "health plan" must select participating providers through a competitive process using objective criteria, including quality, price, services and patient satisfaction; and publish a description of any competitive selection process in advance to permit all interested providers a fair opportunity to participate;
- States may not limit or prohibit competition among providers to participate in a health plan by granting any antitrust exemption;
- Integrated health systems should be prohibited from acquiring or maintaining control of more than 20 percent (20%) of the business in a particular health care product and geographic market; and
- Providers seeking the protection of "safe zones" under the new Justice Department guidelines and Federal Trade Commission rules must publish a notice in a local newspaper describing the nature of the project.

II. Acquisitions of HME Companies by Non-profit Hospitals

In recent years, many non-profit hospitals have established or acquired HME companies, ostensibly to provide "one-stop shopping" for people who are being discharged from the hospital. On the surface, such a concept may sound like a more simplified, cost-effective approach to administer health care. This approach, which aims to eliminate the confusing bureaucratic maze and paperwork patients face when coping with a post-acute medical

episode, could appear attractive at first. Yet, it has not taken long for many health care providers to determine that such "vertical integration" is *not* as wonderful as some claim and, in fact, has led in essence to "captive referrals".

The following problems either exist today or could occur for consumers, government agencies, HME suppliers and local communities due to hospital ownership of HME businesses:

- Non-profit hospitals may refer patients to their own HME companies, wherever one exists, without the patients having knowledge of other options — in other words, patients would not be provided with a choice of provider;
- Hospital-owned HME companies could drive existing independent HME suppliers out of business, thereby creating a monopoly situation that would allow hospitals to control the home care marketplace — eventually, patients would have no choice available to them;
- Continued "self-referral" of Medicare patients could cost the government more money in the long run, similar to the problems that occurred with physician self-referral under Medicare;
- Private pay patients, who belong to a hospital-run health plan and are referred by the hospital for HME services, could receive reduced care in order to allow the hospital to lower costs and save money; and
- There would be a loss of tax revenue as well as jobs within the community if non-profit hospitals eliminate for-profit independent HME companies from the marketplace.

A. Limited Choice of Provider

As noted above, one of the major concerns that many Americans have regarding Congressional reform of our nation's health care system is whether they still will be able to choose their own health care providers. Non-profit hospitals which own HME companies and refer patients to them do not always provide their patients with a list of other HME suppliers in the area from among which to choose. As such, no option is provided to these patients that would enable them to choose an HME supplier based on price and quality of care.

After a medical episode occurs, many patients simply follow the recommendation of their hospitals' discharge planners. Few patients have enough experience in dealing with specific HME suppliers prior to their inpatient stays to judge where they would receive the highest quality of service. Discharge planners have become very adept at evaluating providers and making referrals to those companies best able to meet their patients' needs. However, when a hospital discharge planner's employer becomes the HME provider as well, undue pressure exists which may not be in the patient's best interest. This undue pressure could interfere with the discharge planner's role as patient advocate.

These types of referral arrangements present problems similar to those that previously have arisen with physician self-referrals. Consumer problems associated with physician self-referrals were discussed as early as October 1991, in testimony presented by Mark N. Cooper, Ph.D., Director of Research for the Consumer Federation of America, at hearings on "Physician Ownership and Referral Arrangements" held by Representative Pete Stark (D-CA), Chairman of the House Ways and Means Subcommittee on Health. Dr. Cooper testified then that "the American people understand this problem well...they find it difficult to shop for ancillary medical services. The reason is clear; since physicians order them, and physicians read them, consumers cannot and do not shop....The American people want their doctors to be doctors, not to be profit makers by selling them ancillary medical services."

Clearly, limited choice for patients occurs when hospitals self-refer. In a recent case, Advanced Health Care Services v. Radford Community Hospital, the plaintiff, a home medical equipment supplier, alleged that two hospitals in his area had entered into an exclusive agreement with a competing supplier to provide equipment for patients discharged from the hospital. The plaintiff further alleged the following: the hospitals directed the discharge planners to refer all business to the supplier with whom they contracted, often

without consulting patients; the hospitals received 65% of all revenues generated by their HME referrals; and the hospitals' discharge planners were paid $40 for each patient ordering equipment from the HME supplier. Although a lower court dismissed the complaint, the appeals court held that the plaintiff had established sufficient basis for proceeding and should be permitted to conduct discovery in support of its claims. The higher court understood that patients in this case were not given a choice of selecting an HME supplier and that a monopoly situation had been established.

B. "Self-Referral" of Medicare Patients

In the recent past, Congress has taken a hard look at and acted to eliminate the practice of physicians referring their patients to medical entities for which they had a financial interest. With the passage of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), any physician participating in the Medicare and Medicaid programs is prohibited after January 1, 1995 from referring patients to a number of ancillary medical services with which the physician may have a financial relationship (e.g., clinical laboratory services; physical and occupational therapy; radiology or other diagnostic services; radiation therapy services; durable medical equipment; parenteral and enteral nutrients, equipment, and supplies; prosthetics, orthotics, and prosthetic devices; home health services; outpatient prescription drugs; and inpatient and outpatient hospital services). Clearly, these provisions in OBRA '93 reveal Congress understood that some physicians were taking unfair advantage of their special patient-physician relationship by referring patients to their physician-owned ancillary services.

A number of studies and data support Congress' concerns. A 1989 General Accounting Office (GAO) study of Pennsylvania and Maryland clinical laboratory services indicated that the use of physician-owned facilities was higher than that of non-physician-owned

laboratories and that their average cost per service was higher. Similarly, a 1989 HHS Office of Inspector General report concluded that "patients of physicians, who have a financial interest in the entity to which they referred, received 45% more clinical laboratory services and 13% more physiological laboratory services." This increased utilization of clinical laboratory services by patients of physician-owners cost the Medicare program an estimated $28 million nationally in 1987.

During the House Ways and Means Health Subcommittee October 1991 hearings on Physician Ownership and Referral Arrangements, Congressman Stark stated it best: "Physician ownership/referral arrangements represent an exploding virus which ultimately will erode the trust that patients have traditionally placed in their physicians. The sad thing is that we are quickly getting to the point where each of us is going to have to wonder if we are getting a service because we need it, or because it would increase our physician's dividend check." This same concern should exist with regard to hospitals which have a financial interest in ancillary medical services, such as HME; indeed, the two situations are very similar.

Interestingly, the opposite could occur in those situations where hospitals decline to refer private pay patients within their hospital-run plans. Hospitals increasingly are developing their own health networks or plans. This has allowed hospitals to be both the medical and financial gatekeeper for their patients. Stories already have been told of situations where testing or care has not occurred as a way of saving money for a third party payor, such as a health maintenance organization (HMO). This obviously puts the patient at risk. In this age of concern about rising health costs, we could very well witness an increasing number of cases where patients are "short changed" by the health care gatekeeper due to financial considerations.

C. HME Companies Are Being Driven Out of Business

Non-profit hospitals potentially could drive existing independent HME suppliers out of business by self-referring their less informed patients, thereby creating a monopoly situation which could further control the health care marketplace. Many HME companies already have suffered from hospital entry into the HME services industry. On the surface, this "competition" may seem harmless. But this cannot be considered competition in the truest sense, especially when patients are not informed that they have a choice of HME providers outside the hospital-owned entity.

Scenarios that depict hospitals as having an unfair competitive advantage are now making their way into the courts. In the case of M&M Medical Supplies v. Pleasant Valley Hospital, the court reversed a lower court ruling that the hospital was the sole hospital in the relevant market and its discharged patients were the primary consumers of HME in the market. Patients were not notified that all HME was ordered from the hospital's subsidiary; they were not given a choice of HME supplier; and competing suppliers were excluded from the hospital. The court concluded that this activity could support a claim of monopolization and attempted monopolization.

Finally, in the future, particularly if non-profit hospitals eliminate HME companies from the marketplace, a loss of tax revenue as well as jobs within the community would result. NAMES has learned from HME suppliers across the country the economic hardships they face when a non-profit hospital-owned HME company opens for business. Since such hospitals are offering other ancillary services as well, it is only a matter of time before smaller HME companies close their businesses, leaving many families without an income.

Recommendation

NAMES recommends that Congress closely examine the relationship between hospital-owned and independently owned ancillary services, to determine the problems associated with this type of service delivery system. Studies such as those the GAO conducted on physician self-referral arrangements are a good place to begin such an examination.

TESTIMONY OF

F. DEWAYNE FOSKEY, BOARD MEMBER

on behalf of

THE NATIONAL CHILD CARE ASSOCIATION

before the

COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON PROCUREMENT, TAXATION AND TOURISM

UNITED STATES HOUSE OF REPRESENTATIVES

on

UNFAIR COMPETITION BY GOVERNMENT ENTITIES

JUNE 16, 1994

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F. DEWAYNE FOSKEY, BOARD MEMBER
on behalf of
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Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear before you today on behalf of the National Child Care Association (NCCA). My name is Dewayne Foskey and I own a chain of licensed private child care centers in South Georgia and in the Atlanta area. As a Board Member of the National Child Care Association and an owner highly impacted by the inequities of government and non-profit competition, I have been asked to bring the concerns of this vital industry to your attention.

The National Child Care Association represents the largest single provider of early childhood care and education in the nation -- namely, the private sector. Most of the members of NCCA are tax paying, not tax consuming, small business proprietors of single center operations. It is important to understand that we are the classic small business....only 9% of the available child care in this country is provided by the large chains. This industry cares for well over six million children daily and strives to provide quality, developmentally appropriate environments with loving and nurturing staff. We not only have the privilege of being a child's second teacher and caregiver (after its parents), but we contribute heavily to the economic and business development of our communities and country by allowing parents the peace of mind to pursue jobs and careers. As an industry, we contribute directly to the nation's well-being and future by taking the first National Education Goal seriously; that is, we endeavor to ensure that every child we serve enters school ready to learn. Economically, our contribution is the employment of over 800,000 individuals, as well as our corporate contribution to the tax coffers. It is worth noting that there are close to 90,000 private, licensed child care programs in the nation generating annual revenue of $25 billion, and over 50 percent of those programs are operated as profit making businesses.

As an industry, we have committed ourselves and our futures to the provision of quality care. We know our industry plays a vital role in America's business and economic development. Over the past twenty years, we have had large and small assaults on our ability to remain a viable industry.....from skyrocketing liability insurance rates to obscure, costly regulatory changes. We have focused on our task of providing affordable child care to millions of young working families despite increasing regulatory pressures which raise the cost of licensed child care. We will continue to use our creativity and ingenuity to maintain an environment which preserves the ability to provide the highest quality service to the families we serve at a price they can afford.

While I would like to focus on the inequities created by non-profit competition (which are prevalent throughout our industry), I think it best to take this opportunity to acquaint you with a very serious problem confronting us ... a problem that we cannot "fix" without help. I believe our situation is perhaps different from the other scenarios you are considering because it is not blatant competition; it is subtle and insidious; our competitor is successful because it offers a service at little or no cost to the individual at the expense of the taxpayer. Our competitor has access to a captive market, has locations that are convenient and it is trendy! Our largest single government competitor is our nation's public school systems. While struggling to do their primary job adequately, the public school systems are literally putting themselves into the child care business. They are openly boasting of making profits and, backed by tax subsidies, are successful despite the level of service they provide and the lack of minimum health and safety regulatory compliance.

It was not too many years ago that the schools reached out to "embrace" our nation's five year olds. Not only does the early childhood community continue to struggle with the economic loss of those children, many early childhood academicians and professionals question the wisdom of putting preschool children in unprepared, structured public school environments. Can you imagine our dismay and fear as we watch state after state initiate four-year-old kindergarten programs in their public schools? Again, we face a serious readjustment to our services and a frightening vision of the high probability that three-year-old child care programs will soon be standard operating procedure in the schools.

In addition to the growth of three-, four- and five-year-old, public school-based programs, we are highly impacted by yet another non-traditional "service" provided by the public schools ... before- and after-school child care. School systems are randomly initiating school-age care programs under the guise of providing much needed latchkey care. We have a school system in Georgia in an affluent county which provides after-school care for over 4,000 children and has documented an annual profit of $250,000! Until last year, the program provided no scholarship program for at risk children, and only because it received funding through the Child Care and Development Block Grant were scholarships awarded last year. School-based programs are not providing services to our substantial at risk, low-income child population.

We are distressed that the school-based programs have not used their advantages to reach out to the child in need. The National Study of Before- and After-School Programs confirms that school-age programs serve a small percentage of children -- 12 percent -- from families receiving public assistance. Only 21 percent of the children attending programs sponsored by the public schools receive free or reduced price meals. In reality, the children the schools are serving are the very same fee-paying children who have left my centers. We can hardly blame their parents for taking advantage of a reduced fee subsidized by the taxpayer. But, we can blame the schools for not serving the children who need care the most because these families can't afford even reduced fees.

The private child care community cannot continue to operate in a regulatory environment which drives our cost of quality care higher and higher while forcing us to compete for the very same children with unlicensed school-based programs that use our tax dollars to provide buildings, equipment, personnel and food at little or no cost to the school-age program.

It is important that you understand the economies of child care to really appreciate what a serious detrimental cycle is created by this government competition. Not only are thousands of small business child care providers impacted economically, but you and I should be very concerned about the adverse impact this cycle is having on the availability of child care for all ages in a time when more, not less, is needed. Because the cost of quality infant and toddler care is so high, centers subsidize that care through three-, four- and five-year-old programs as well as school-age programs. It is very simple economics....without the 3s, 4s and 5s and the school-age population, the cost of infant and toddler care will necessarily rise to more adequately reflect its true cost. As the cycle continues, parents will not be able to afford the increased fees, centers will close and the availability of infant/toddler care in regulated, safe child care situations will decline. So you see, what is happening not only affects the ages we've talked about, but the entire early childhood care picture.

I would like to share some worrisome statistics which support our contention that the industry is truly suffering from the unfair competition created by school-based child care programs. The 1994 Child Day Care Licensing Study, prepared by the Children's Foundation, reports that licensed child care is decreasing in our nation at a time when the economy is growing and jobs for young parents are more plentiful. The number of licensed centers in the United States and its territories dropped from 90,558 a year ago to 89,735 last fall. While not a big drop, it is the first time since we have collected accurate data that this has happened. Even during the sluggish 1991 and 1992 economies, there was a 5 percent growth in licensed centers. The impact of government competition on the private child care sector is real and it is significant.

As long ago as 1989, La Petite Academy, the nation's second-largest chain with centers in thirty states, all with school-age care, reported the loss of 3,000 slots to public schools in a single year.

In the January/February 1991 issue of Child Care Information Exchange, a trade publication, the top 50 owners of child care companies, representing a total of 3,492 centers, felt that an even greater concern for them than the current economy was the growing competition from public school systems. Nearly 100 percent of the owners identified this as their number one threat.

In a small west Georgia county, the decision of the public schools to provide before- and after-school care despite a plea from the private child care community validating an abundance of available slots (at least 300) in the county's private sector, has had a devastating impact. Over three years, the public school programs have grown to nearly 300 children predominantly from middle-income families. The program has few, if any, low-income children -- precisely those who are "at risk" and in need of care. Officials of the schools now openly admit they are in direct competition with private centers and exploit their tax exempt status by: setting fees well below market rates; aggressively marketing through teachers, school newsletters, PTA meetings, etc.; not allowing centers to market their programs in the schools; and offering no full cost accounting for fair rent, utilities and other expenses. Anyone who understands supply and demand can imagine the results. When the school programs started, centers serving school age children were dramatically weakened. The industry responded by laying off staff, raising fees to other parents to offset losses, and eliminating three expansion projects and several renovations

plans. Worst of all, three centers have been forced to completely close citing the public school programs as a major contributing factor. That resulted in the loss of over 300 much-needed child care spaces and the loss of 25 jobs. Overall, the centers in this small, rural area estimate $360,000 in lost revenues and 40 jobs cut over the past three years and a reduction of 20 percent of the market capacity due to centers closing. Currently, the schools continue to drain an estimated $250,000 per year away from tax-paying centers while hundreds of school-age spaces sit empty at private centers.

Now, let me share a personal scenario involving my company, Children's Friend. My company operates 28 early childhood centers. Twenty-five of those provide early care as well as school-age care. Three of our programs are dedicated to school-age care. Children's Friend was founded in 1976 with a corporate commitment to bring quality, affordable child care to South Georgia which was underserved at the time. Children's Friend has grown steadily in South Georgia. The competition from public school-based after-school child care programs was not a factor in my company's business plan in 1976, but circumstances have certainly changed since that time. Now, my company's ability to grow has been compromised by public school-based child care programs.

In 1990-1991, two programs in Columbus, GA were operating at full capacity caring for a total of 365 children, over 150 of those being school-age children. Our decision to expand the building at one site to accommodate an apparent need and demand was a substantial financial commitment for a company such as ours. But, we made it based on a thorough study of the data. In 1992, nearby public schools announced that they would be opening after-school child care programs. Children's Friend today -- two years later -- has not recovered from this loss because we now have only 250 children at these two sites and a building we are unable to use. There was almost an instantaneous loss of over 115 children -- all school-age.

Children's Friend is behind $200,000 in annual revenue on these two programs alone. We have not been able to re-hire the ten staff people and teachers we were forced to release. Although it has been very difficult, we have had the ability to spread our losses company-wide. I do not know how a single operator can survive this kind of impact. And now data is beginning to show that they simply are not surviving.

During 1992 and 1993, public school-based after-school programs have opened in Albany and Macon. I am sorry to report that my company is seeing similar results and impacts.

Because small business is known for its problem solving capability, I would like to suggest some solutions to our dilemmas.

Equal Protection of All Children Needs to be a National, State and Local Policy Priority
Our professional lives, and I daresay many of our personal lives, are spent in the consuming pursuit of providing a quality environment for children. We are advocates of equal protection for all children. We believe that minimum health and safety standards should be applied to all out-of-home child care programs. The vast majority of public school-based programs are not licensed. The study "Caring for Our Children - National Health and

Safety Performance Standards: Guidelines for Out-of-Home Child Care Programs" was jointly written by the American Academy of Pediatrics and the American Public Health Association. It states:

> "Because standards are directed toward the protection of children, every child has a right to care that meets the standards, regardless of the child care setting in which the child is enrolled. Public and private schools, nurseries, preschools, centers, child development programs, babysitting centers, early childhood observation centers, small and large family-child-care homes, and all other settings where young children receive care by individuals who are not close relatives should be regulated.... Nothing in the educational philosophy, religious orientation, or setting of an early childhood program inherently protects children from health and safety risks or provides assurance of a level of quality of child care. Any exemptions for care provided outside the family may place children at risk."

It is good policy and practice to ensure that our young families' children are cared for in safe and healthy environments. For us, equal protection of children is paramount, but by requiring that the playing field be leveled in terms of the regulatory environment, we can compete more fairly, even though the schools still enjoy the advantages of reduced overhead through the use of public buildings.

Non-Traditional Public School Programs Must Concentrate on At Risk Children as Their First Priority

The government, responsible for tax expenditures, should encourage the public schools to concentrate their child care programs on "at risk" children first, and only if quality child care is not available in the private sector.

True Collaboration Followed by True Partnerships Must Take Place Between the Public and Private Early Education Communities

School systems should be given mandates and/or incentives to collaborate with the private early childhood community in the provision of three-, four- and five-year-old kindergartens and school-age programs. Some encouraging models are being developed (particularly with the three- and four-year-olds) which utilize the resources of the private sector to support public pre-kindergartens and school-age programs. These have the potential to be beneficial partnerships which utilize available community resources and provide a needed service. But, I must report that the industry is skeptical about these models because traditionally we have been forced out of collaboration by the non-profit and public sectors.

Linkages Must be Formed for the Good of the Children and for Preservation of Early Childhood Care and Education Options

The public schools should begin the process of rebuilding linkages to the private preschool community that have been destroyed over the past few years. Private preschools should be considered as partners in the educational process and every effort should be made to improve the relationship between the two groups. Such efforts should include elimination of current and future programs that duplicate services already offered by preschools;

enhancing preschool curriculums for school readiness; ensuring a smooth transition from preschools to public schools; allowing centers to advertise through the public schools; and streamlining bus schedules.

NCCA understands that there is a role for the public schools in child care. There will always be areas of our country that have no other options for child care other than schools and there will always be pockets which cannot be served by the private sector for one reason or another. But, with proper funding and a true need, I can almost guarantee that the private early childhood care and education community can accommodate any situation. We have a proud history of providing early care and education to America and we know how to do it efficiently and effectively. Unfortunately, we are a community resource that is often overlooked simply because we are in the private sector.

In closing, the bottomline is: Do we want early childhood care and education to be the next entitlement program for the United States? If the answer is no, then Congress needs to act now to redirect the early care and education in our country. If the answer is yes, then get out your checkbook! Prepare yourself for gigantic increases in the demand for child care through the school systems. In this scenario, the private sector industry will continue to decline. Eventually, the only option parents will have is care through public education.

STATEMENT OF THE YMCA OF THE USA
PRESENTED BY MICHAEL P. GRAVES, PRESIDENT
YMCA OF DELAWARE
SUBCOMMITTEE ON PROCUREMENT, TAXATION, AND TOURISM
HOUSE SMALL BUSINESS COMMITTEE

June 16, 1994

Introduction. More than 2,000 YMCAs across the nation, serving 13 million people each year, nurture children, support families, and strengthen communities. YMCAs are not private health clubs; they are multipurpose human service organizations providing a broad range of services to their communities. The YMCA mission remains what it always has been: putting Christian principles into practice through programs that build healthy bodies, minds, and spirits for all.

YMCAs respond to community need. The facilities we construct and the programs we offer reflect the decisions of local community boards that include many small businessmen and women. This local control assures that YMCAs stay in touch with their communities and are responsive to changing community needs. No one owns a YMCA; no one profits from it.

YMCAs could never function without the generous support of their communities. The services of 437,000 volunteers are the backbone of the YMCA movement. From board chairs to soccer coaches, these volunteers make the YMCA possible. YMCA supporters also contributed more than $360 million in 1993 to YMCAs across the country.

Youth programs are central to the YMCA's mission. YMCAs are where tens of thousands of young people play basketball, swim, learn gymnastics and play soccer. Whatever the program, the primary emphasis is on growing, not winning. The YMCA's cardinal rule -- that every child plays every game -- captures the spirit of a program built around the values of participation, fun, fitness, teamwork, and fair play. In fact, many private health club members had their first exposure to fitness activities as young people at the YMCA.

Youth camping is another strong YMCA tradition. Since the first YMCA residential camp opened in 1885, YMCA camping has grown to include more than 200 youth resident camps as well as thousands of day camps. YMCA camps serve a large cross-section of youth and YMCA financial assistance assures that many inner city kids have the benefit of YMCA camping.

YMCAs are working hard to increase their programming for teens. Today, too many young adolescents have too much unstructured, unsupervised, and unproductive time. YMCA youth memberships, which generally are heavily subsidized, give these young teens a place to go and the guidance of supportive adults. Many YMCAs also offer specific programs targeted at young adolescents, such as drug and alcohol avoidance counseling, programs for teen parents, drop-in centers, and community service opportunities.

YMCAs serve senior citizens, providing special swimming and exercise programs as well as rehabilitation programs to help seniors, and some younger members as well, recover from debilitating illnesses. YMCAs also offer clubs, seminars, and other programs designed to meet the social and emotional needs of older Americans. YMCAs serve individuals with disabilities through their regular programming, as well as through special programming designed to accommodate particular needs.

YMCAs work collaboratively with other community organizations, opening their programs and their facilities to groups like the Girl Scouts, Big Brothers/Big Sisters, and organizations serving the homeless. YMCAs also routinely collaborate with local schools in a range of programs from swim lessons to providing practice facilities for school teams. These uses of YMCA facilities are an important way that YMCAs serve their communities.

Child Care. Strengthening families and meeting the needs of children remains central to the YMCA mission of building healthy bodies, minds, and spirits for all. Their commitment to serving children and families has led YMCAs to respond quickly and energetically to families' rapidly growing need for affordable, high quality child care. YMCAs collectively are America's largest provider of child care, serving over 500,000 children and their families in pre-school, before-school, and after-school programs.

Making safe, quality child care available to working families, regardless of their ability to pay, is a priority issue for YMCAs. As in other YMCA programs, those who can afford to pay a fee do; those who cannot receive subsidies. YMCA child care programs provide a common ground, where children of all economic levels, from the affluent to the disadvantaged, can receive the same quality care in the same setting.

YMCA and other nonprofit charities offer parents a diversity of choice in child care providers. Many families seek child care in a setting that emphasizes, as YMCA programs do, the nurturing of essential values in growing children. YMCA child care curricula reflect the YMCA's commitment to helping children become aware of their values, improve their decision-making skills, and begin to understand the connection

between values and behavior. YMCAs also incorporate into child care their traditional commitment to building cultural, racial, and international understanding, as well as to developing children's leadership abilities.

Wellness Programs. YMCAs have been promoting health and fitness for over 100 years. We began opening gymnasiums in the 1850s and swimming pools in the 1880s. Today, YMCA adult programs help over 6 million Americans develop the physical, mental, and spiritual strength and self-confidence to be more effective parents, workers, and citizens. Through comprehensive and medically sound wellness programs such as physical fitness, nutrition and weight management, stress management, human relations, and substance abuse prevention, YMCAs help participants clarify their values and live healthier lives.

The need for wellness programs has never been more urgent. The societal cost of health care is approaching 14% of GNP, a figure that does not include the economic cost of lost productivity. Regular physical fitness promotes health by preventing or reducing the severity of coronary artery disease, playing a key role in effective weight loss programs, and in preventing or controlling other diseases such as diabetes, hypertension, and osteoporosis, as well as disabling back injuries.

Despite the acknowledged benefits of regular physical activity, the Surgeon General reports that less than half the adult population exercises three or more days per week for twenty minutes or longer. Less than 10% exercises three or more times a week at the vigorous level necessary to improve cardiorespiratory fitness. YMCA wellness programs help to fill this gap.

YMCA financial assistance policies make YMCA wellness programs widely available to the community. YMCA fees and dues are set at levels that most can afford and financial assistance is available for those who cannot pay. The YMCA's goal is to support and encourage all members of the community in undertaking the regular physical exercise that will help them lead healthier lives.

YMCAs Differ From Private Health Clubs in Important Ways. YMCAs differ from commercial health clubs in many ways. The most important is that YMCAs serve the whole community, young and old, rich, poor and in-between, while commercial health clubs understandably concentrate on middle and upper income adults. YMCAs also offer many services you will seldom find in a private health club: after-school child care, youth sports, and parent-child programs to name just a few.

YMCAs have a 100-year record of quality and reliability. While there are many excellent private health clubs, there is also a well-documented history of fitness fads, consumer fraud, and bankruptcy. This is most recently evidenced by the Federal

Trade Commission's announcement that the largest health club chain in the country, Bally's Health and Tennis Corporation, will pay $120,000 in civil penalties to settle charges that its clubs overbilled, harassed, or ruined the credit rating of customers nationwide.

YMCAs belong to their communities. They are controlled by broad-based community boards. Their revenues are used for community service, not for private profit.

YMCAs Meet All Applicable Standards for Tax Exemption. The Internal Revenue Service ruled in 1984 that YMCA fitness programs would be subject to the unrelated business income tax unless the YMCA can demonstrate that its fitness members reflect the makeup of the general population of the community. This test applies to each YMCA facility and, if the YMCA has two or more membership categories, to each membership category. YMCAs have never failed this test.

Three recent decisions from appeals courts in three different states affirm that YMCAs also continue to meet stringent state standards for property tax exemption. All three of these cases resulted from complaints of unfair competition: two by health clubs and one by a for-profit child care center. The California Court of Appeals upheld property tax exemption for the Oakland YMCA's downtown facility against a challenge by an organization known as Clubs of California for Fair Competition. The Oregon Supreme Court upheld the reinstatement of tax exemption for the Portland YMCA's downtown facility against a challenge by an organization known as Northwest Alliance for Market Equality. Finally, the Iowa Supreme Court affirmed a trial court's decision that a YMCA child care center is charitable, a case that began with a complaint from a competitor. Over the past several years, numerous other local tax officials have reviewed YMCAs' tax exemptions following complaints by health clubs and have uniformly concluded that YMCAs continue to deserve their charitable tax exemptions.

The Business Coalition for Fair Competition's Model Bill Would Radically Alter the Relationship Between Charities and Their Communities. Some small businesses argue that charity should be limited to serving the poor and support the radical proposal that tax exemption be eliminated for all activities of nonprofit organizations that have private-enterprise counterparts. Because there is a commercial counterpart for most charitable services, this proposal would strip tax exemption from virtually every charitable organization. Charities would suddenly find themselves with income, property and sales tax obligations simply because a service is available, for a price, from a business.

This proposal would impact many more human services organizations than just YMCAs. A wide range of services from family counseling through alcohol rehabilita-

tion services are available from both nonprofit human services organizations and from private providers. Like YMCAs, most human services organization get part of their income from fees for services. Taxing these organizations because their services also are available from private providers for a price would radically alter historic relationships in communities across America.

The narrow concept of charity our critics propose would break the bond between charities and their communities. Communities across America support their YMCAs because in a very real sense the YMCA is the community. Narrow the YMCA's role to serving only a part of that community and you risk severing the very relationships that keep the YMCA alive and working for all.

Conclusion. YMCAs contribute many important services to their communities. But the most important contribution of YMCAs may well be the values that they and other charities create, nurture and sustain. YMCAs stimulate members of their community to contribute generously of their time and money to help others. They offer a choice to individuals seeking services that reflect and affirm their values. They contribute in important ways to building a sense of community in the areas they serve. These key values -- altruism, pluralism, and community -- are fundamental to American society. Business and government alone cannot sustain them. Business and government have a fundamental stake in preserving and strengthening the independent sector.

TESTIMONY BEFORE THE HOUSE SUBCOMMITTEE ON PROCUREMENT, TAXATION, AND TOURISM

BY

JOHN KEMP, EXECUTIVE DIRECTOR
UNITED CEREBRAL PALSY ASSOCIATIONS
AND
BOARD MEMBER, INDEPENDENT SECTOR

JUNE 16, 1994

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

THANK YOU FOR THIS OPPORTUNITY TO PRESENT TESTIMONY ON THE BEHALF OF INDEPENDENT SECTOR AND ITS MEMBERS BEFORE THE SMALL BUSINESS SUBCOMMITTEE ON PROCUREMENT, TAXATION AND TOURISM ON THE SUBJECT OF UNFAIR COMPETITION FROM NONPROFITS.

MY NAME IS JOHN KEMP. I AM THE EXECUTIVE DIRECTOR OF UNITED CEREBRAL PALSY ASSOCIATIONS AND A BOARD MEMBER OF INDEPENDENT SECTOR.

INDEPENDENT SECTOR IS A NATIONAL COALITION OF OVER 800 VOLUNTARY ORGANIZATIONS, FOUNDATIONS, AND CORPORATE GIVING PROGRAMS WITH NATIONAL INTEREST AND IMPACT IN PHILANTHROPY, VOLUNTARY ACTION AND OTHER ACTIVITY RELATED TO THE EDUCATIONAL, SCIENTIFIC, HEALTH, WELFARE, CULTURAL AND RELIGIOUS LIFE OF THE NATION. BASED IN WASHINGTON, D.C., THE ORGANIZATION WAS FOUNDED IN 1980.

FIRST, LET ME TAKE A FEW MINUTES TO TELL YOU ABOUT TAX-EXEMPT NONPROFIT ORGANIZATIONS AND THE ROLES THEY PLAY IN OUR SOCIETY AS A WHOLE. IS REPRESENTS A BROAD AND DIVERSE THIRD SEGMENT OF AMERICAN SOCIETY, ALONG WITH GOVERNMENT AND BUSINESS. THE NATION'S NEARLY ONE MILLION CHARITABLE, EDUCATIONAL, RELIGIOUS, HEALTH, AND SOCIAL WELFARE ORGANIZATIONS CREATE, NURTURE, AND SUSTAIN THE VALUES THAT FRAME AMERICAN LIFE. THEY PROMOTE ALTRUISM, IN A SOCIETY THAT REINFORCES SELF INTEREST; COMMUNITY IN A SOCIETY THAT REWARDS INDIVIDUAL ACHIEVEMENT; AND PLURALISM IN A SOCIETY SOMETIMES THREATENED WITH DIVISIVENESS. THEY PROVOKE, CHALLENGE, AND QUESTION. THEY ALSO TEACH, MEDIATE AND HEAL. IN 1989 ALONE, CHARITIES SPENT AN ESTIMATED $389 BILLION IN PROVIDING VAST AND VARIED HUMAN SERVICES. THAT SAME YEAR, NEARLY 100 MILLION PEOPLE VOLUNTEERED THEIR SERVICES – FROM MEALS ON WHEELS TO SERVING IN HOMELESS SHELTERS, TO ADVOCATING FOR CIVIL RIGHTS.

IN RECENT YEARS, SOME REPRESENTATIVES OF THE BUSINESS COMMUNITY AND THE SMALL BUSINESS ADMINISTRATION HAVE CHARGED THAT NONPROFIT ORGANIZATIONS HAVE AN UNFAIR COMPETITIVE ADVANTAGE OVER FOR-PROFIT BUSINESSES BECAUSE OF OUR TAX-EXEMPT STATUS.

I WOULD LIKE TO ADDRESS THAT ISSUE, STARTING WITH OUR OPPONENTS' ARGUMENTS.

1. OUR OPPONENTS' ARGUMENTS

THOSE WHO CLAIM THAT NONPROFITS COMPETE UNFAIRLY WITH BUSINESSES ARGUE THAT EXEMPTION FROM FEDERAL INCOME TAX AND OTHER TAX EXEMPTIONS CONSTITUTE GOVERNMENT SUBSIDIES TO NONPROFITS WHICH PROVIDE AN UNFAIR COMPETITIVE ADVANTAGE WHEN A NONPROFIT AND A FOR-PROFIT ARE

OPERATING IN THE SAME MARKET.

SOME OF THE NONPROFIT ACTIVITIES ALLEGEDLY INVOLVING UNFAIR COMPETITION INCLUDE: FITNESS CENTERS, DAY CARE FACILITIES, NURSING HOMES, HEARING AID SALES, RESEARCH AND DEVELOPMENT WORK, TRAVEL SERVICES, AND CONSULTING ACTIVITIES.

2. **BOTH FOR-PROFIT AND NONPROFIT ORGANIZATIONS SERVE THE PUBLIC GOOD BUT IN DIFFERENT WAYS.**

THE EXCLUSIVE PURPOSE OF THE NONPROFIT ORGANIZATION IS TO PROMOTE THE PUBLIC GOOD. THIS PURPOSE IS FULFILLED THROUGH ACTIVITIES SUCH AS EDUCATION; CONDUCTING OR PROMOTING CULTURAL, RELIGIOUS, OR SCIENTIFIC ACTIVITIES; PROVIDING THOSE IN NEED WITH FOOD, CLOTHING OR SHELTER; FOSTERING SELF-HELP; AND ADVOCATING CHANGES IN PUBLIC POLICY.

FOR-PROFIT BUSINESSES ARE, OF COURSE, THE UNDERPINNING OF OUR NATIONAL ECONOMY, PROVIDING THE JOBS AND THE TAX REVENUE WHICH MAKE THE AMERICAN ECONOMY FUNCTION. FOR-PROFIT BUSINESSES WHICH PROVIDE SOCIAL SERVICES MAY SERVE THE PUBLIC GOOD, BUT THEIR PRINCIPAL PURPOSE IS TO MAKE A PROFIT. THIS DISTINCTION IS RECOGNIZED BY THE U. S. TREASURY REGULATION WHICH STATES THAT, "AN ORGANIZATION IS NOT ORGANIZED AND OPERATED EXCLUSIVELY FOR ONE OR MORE OF THE PURPOSES SPECIFIED IN SECTION 501(c)(3) UNLESS IT SERVES A PUBLIC RATHER THAN A PRIVATE INTEREST." (TREASURY REGULATION SECTION 1.501(c)(3)-1(d)(ii).)

3. **NONPROFIT ORGANIZATIONS DO NOT HAVE "PROFITS" IN THE SAME SENSE THAT PRIVATE BUSINESSES DO.**

ALL PRIVATE BUSINESSES, HOWEVER PUBLIC SPIRITED, ARE RUN TO PRODUCE A PROFIT FOR THEIR OWNERS. BY CONTRAST, IF A NONPROFIT HAS AN EXCESS OF REVENUE OVER EXPENSES, A RELATIVELY RARE OCCURRENCE, THE SURPLUS MUST BE USED FOR THE CHARITABLE PURPOSES OF THE ORGANIZATION. SUCH SURPLUSES ARE TYPICALLY USED BOTH TO COVER DEFICITS IN OTHER YEARS AND TO SUBSIDIZE FREE OR REDUCED-COST SERVICES TO LOW INCOME PEOPLE.

4. **THE ABILITY OF NONPROFITS TO RECEIVE TAX DEDUCTIBLE CONTRIBUTIONS PROVIDES IMPORTANT PUBLIC BENEFITS.**

NONPROFIT ORGANIZATIONS RECEIVE CONSIDERABLE BENEFIT FROM CHARITABLE CONTRIBUTIONS OF MONEY AND VOLUNTEER TIME. THE ABILITY OF NONPROFITS TO RECEIVE TAX DEDUCTIBLE CONTRIBUTIONS OF GOODS AND SERVICES GREATLY ENHANCES THEIR ABILITY TO SERVE THE PUBLIC GOOD BY ENABLING THEM TO PROVIDE FREE OR REDUCED-COST SERVICES TO THOSE WITH MODEST INCOMES.

5. **NONPROFIT ORGANIZATIONS WHICH ENGAGE IN BUSINESS ACTIVITIES MUST PAY FEDERAL INCOME TAXES ON THOSE ACTIVITIES.**

NONPROFIT ORGANIZATIONS MUST PAY FEDERAL INCOME TAXES, AT REGULAR CORPORATE RATES, ON ALL INCOME-PRODUCING ACTIVITIES WHICH DO NOT CONTRIBUTE TO ACCOMPLISHING THEIR EXEMPT PURPOSE. AN ACTIVITY OF A NONPROFIT ORGANIZATION IS SUBJECT TO THE SO-CALLED "UNRELATED BUSINESS INCOME TAX" IF IT IS (1) A 'TRADE OR BUSINESS," (2) "REGULARLY CARRIED ON," AND (3) NOT "SUBSTANTIALLY RELATED" TO THE ORGANIZATION'S EXEMPT PURPOSES. THE EXPENSES OF CARRYING OUT A NONPROFIT ORGANIZATION TAX-EXEMPT PROGRAM CANNOT BE USED TO OFFSET TAXABLE INCOME.

6. **A LARGE BODY OF LAW EXISTS ON THE SUBJECT OF WHETHER INCOME EARNED BY NONPROFITS IS SUBJECT TO FEDERAL INCOME TAX.**

AS WITH ALL OTHER FEDERAL TAX ISSUES, THESE DETERMINATIONS ARE MADE BY THE IRS, SUBJECT TO REVIEW BY THE COURTS. EXEMPT ORGANIZATIONS' RETURNS ARE REGULARLY AUDITED BY THE IRS, AND LIABILITY FOR UNRELATED BUSINESS INCOME TAX ALWAYS SUBJECT TO EXAMINATION. OVER THE YEARS, COURT DECISIONS, IRS RULINGS AND DETERMINATIONS IN INDIVIDUAL CASES HAVE DEVELOPED A VERY LARGE BODY OF LAW ESTABLISHING WHICH ACTIVITIES OF NONPROFITS ARE SUFFICIENTLY RELATED TO THE CHARITABLE PURPOSES OF THE ORGANIZATION TO BE TAX EXEMPT AND WHICH ACTIVITIES ARE SUBJECT TO TAX.

7. **FOR VALID REASONS, NONPROFIT ORGANIZATIONS HAVE INCREASED THEIR RELIANCE ON SOURCES OF REVENUE OTHER THAN CHARITABLE CONTRIBUTIONS.**

IN RESPONSE TO FEDERAL BUDGET CUT-BACKS AND REDUCED TAX INCENTIVES FOR CHARITABLE GIVING, NONPROFITS HAVE INCREASED THEIR RELIANCE ON SOURCES OF SUPPORT OTHER THAN CHARITABLE CONTRIBUTIONS IN ORDER TO MAINTAIN PREVIOUS LEVELS OF SERVICES.

BETWEEN 1982 AND 1992, FEDERAL SPENDING IN THE AREAS OF GREATEST CONCERN TO NONPROFIT ORGANIZATIONS, EXCLUSIVE OF MEDICARE AND MEDICAID, DECLINED A CUMULATIVE TOTAL OF $123 BILLION COMPARED TO WHAT WOULD HAVE BEEN SPENT HAD FY-1980 LEVELS BEEN MAINTAINED.

8. **IT IS NOT TRUE THAT THERE HAS BEEN A MAJOR TREND OF NONPROFIT ORGANIZATIONS TO ENTER INTO, ON A TAX-EXEMPT BASIS, AREAS TRADITIONALLY CARRIED OUT BY FOR-PROFIT BUSINESS.**

IN FACT, THE REVERSE IS TRUE. IN MANY AREAS PIONEERED BY NONPROFITS, SUCH AS EXERCISE FACILITIES, HEALTH CARE, HOMES FOR THE AGED, AND A WIDE VARIETY OF SOCIAL SERVICES, FOR-PROFITS HAVE BEGUN COMPETING

EXTENSIVELY TO PROVIDE SERVICES TRADITIONALLY PROVIDED BY NONPROFIT ORGANIZATIONS. MANY FOR-PROFIT SERVICE PROVIDERS WHICH COMPETE WITH NONPROFITS, PARTICULARLY IN THE AREAS OF HOME HEALTH CARE AND DAY CARE, DOMINATE THEIR MARKETS. ENTRY BY FOR-PROFITS INTO AREAS TRADITIONALLY SERVED BY NONPROFITS HAS OCCURRED PRIMARILY WHEN THIRD PARTY PAYORS (INSURANCE COMPANIES OR THE GOVERNMENT) ENSURE THE FINANCIAL VIABILITY OF THESE ACTIVITIES, AND WHERE THE MARKET HAS GROWN TO INCLUDE A SUFFICIENT POOL OF CONSUMERS WITH THE MEANS TO PAY FOR SERVICES.

AS ONE EXAMPLE OF FOR-PROFITS MOVING AGGRESSIVELY INTO AN AREA TRADITIONALLY SERVED BY NONPROFITS, BETWEEN 1977 AND 1987, THE NUMBER OF FOR-PROFIT SOCIAL SERVICE ESTABLISHMENTS INCREASED 86 PERCENT, THE NUMBER OF EMPLOYEES GREW BY 101 PERCENT AND THE REVENUES EXPANDED BY 92 PERCENT. EXCEPT FOR REVENUE, THE GROWTH OF NONPROFIT PROVIDERS LAGGED BEHIND THIS ACCORDING TO RESEARCH REPORTED BY LESTER M. SALAMON IN "AMERICA'S NONPROFIT SECTOR, A PRIMER."

9. **VERY LITTLE OF THE ANNUAL SOURCES OF FUND OF NONPROFIT ORGANIZATIONS IS FROM "BUSINESS" ACTIVITIES.**

A MYTH IS BEING REPEATED THAT THERE IS $389.3 BILLION IN TAXABLE INCOME IN THE NONPROFIT SECTOR. THAT'S NOT TRUE.

THE TABLE BELOW SHOWS THE TOTAL ANNUAL SOURCES OF FUNDS OF ALL NONPROFIT ORGANIZATIONS.

FOR SOME ORGANIZATIONS, A SMALL PART OF THE INCOME LISTED AFTER DUES, FEES, AND CHARGES--WHICH TOTALS $17 BILLION-- IS UNRELATED BUSINESS INCOME, AND IS THEREFORE TAXABLE.

TOTAL ANNUAL SOURCES OF FUNDS
OF THE INDEPENDENT SECTOR OF 1989
TOTAL $389.3 billion

	Percent	Amount (in billions)
Private contributions	28.5%	$111.0
Government grants and payments	27.0%	105.3
Health service payments	28.7%	111.7
Tuition	6.3%	24.3
Investment income/Endowments	5.1%	20.0
Other dues, fees and charges	4.4%	17.0
	100.0%	$389.3

Source: "Competition Between
For-Profits and Nonprofits,"
By William M. Brodhead, Esq.

10. **NONPROFIT ORGANIZATIONS MAKE VITALLY NEEDED SOCIAL SERVICES AVAILABLE TO THOSE UNABLE TO PAY FOR THEM.**

IT IS IMPORTANT TO KEEP IN MIND THAT FOR-PROFITS TEND TO "SKIM" AFFLUENT CLIENTS AWAY FROM NONPROFIT SERVICE PROVIDERS, THUS CREATING A TWO-TIER SYSTEM OF SERVICES WHERE THE MORE AFFLUENT ARE SERVED BY FOR-PROFIT BUSINESSES AND LOWER INCOME PEOPLE ARE SERVED BY NONPROFITS. IT SEEMS CLEAR THAT ONLY THE RETENTION OF FEDERAL INCOME EXEMPTION BY NONPROFITS WILL ENABLE THEM TO CONTINUE TO PROVIDE FREE OR REDUCED SERVICES TO PEOPLE OF MODEST MEANS.

NONPROFITS PROVIDE A SINGLE SYSTEM OF CARE OF ALL INCOME GROUPS, ESPECIALLY THOSE WHO ARE GEOGRAPHICALLY ISOLATED, WHO ARE SUBJECT TO DISCRIMINATION, AND WHO ARE EXPENSIVE TO SERVE. FOR-PROFITS MAY OFFER SOME SERVICES TO LOW PAYING OR NONPAYING CLIENTS, OR THOSE WITH SEVERE LONG-TERM DISABILITY OR OTHER PROBLEMS, BUT ONLY IN CIRCUMSTANCES WHERE THE TOTAL SERVICE, OVER TIME, MAKES A PROFIT.

11. **NONPROFIT ORGANIZATIONS ARE RESPONSIVE TO THEIR COMMUNITIES.**

THE PRIME CONCERN OF A NONPROFIT ORGANIZATION IS TO FILL AN UNMET NEED IN A PARTICULAR COMMUNITY IT SERVES. THEY ARE TYPICALLY ORGANIZED BY GROUPS OF INDIVIDUALS BROADLY REPRESENTATIVE OF THE COMMUNITY, WHO SERVE AS VOLUNTEERS ON THE BOARDS OF DIRECTORS AND ON COMMITTEES. OFTEN, THE VOLUNTEER HEADS OF THESE ORGANIZATIONS ARE NEIGHBORS OR ARE OTHERWISE KNOWN TO THE PEOPLE BEING SERVED AND THEREFORE PROVIDE AN ADDITIONAL MEANS OF ACCOUNTABILITY.

OF COURSE, BEING RESPONSIVE TO COMMUNITY CONCERNS IS IMPORTANT TO FOR-PROFIT BUSINESSES, TOO, BUT THEIR PRINCIPAL CONCERN MUST ALWAYS BE TO MAKE A PROFIT.

12. **REVENUES RECEIVED BY NONPROFITS INCREASE THE ACCESSIBILITY OF SERVICES TO LOW INCOME INDIVIDUALS**

FUNDS WHICH NONPROFITS RECEIVE FROM PEOPLE WHO CAN AFFORD TO PAY THE FULL COST FOR GOODS AND SERVICES PROVIDED BY NONPROFITS SUBSIDIZE THE PROVISION OF THE SAME GOODS AND SERVICES FREE OF CHARGE OR AT BELOW-MARKET RATES TO THOSE WHO WOULD NOT OTHERWISE BE ABLE TO AFFORD THEM.

NONPROFIT SERVICES SUCH AS FITNESS CENTERS, HOMES FOR SENIOR CITIZENS, PERSONS WITH DISABILITIES, AND OTHER HEALTH CARE FACILITIES MUST BE GENERALLY ACCESSIBLE, FINANCIALLY, TO A SIGNIFICANT SEGMENT OF THE COMMUNITY, ACCORDING TO FEDERAL LAW AND REGULATIONS. FOR-PROFITS ARE

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NOT SUBJECT TO THAT REQUIREMENT.

13. **NONPROFITS ARE ACCOUNTABLE TO THE PUBLIC.**

NONPROFIT ORGANIZATIONS ARE ACCOUNTABLE TO THE PUBLIC THROUGH COMMUNITY-BASED BOARDS OF DIRECTORS, THROUGH REGULATIONS BY THE STATES (USUALLY THROUGH THE STATE ATTORNEY GENERAL), AND BY THE IRS THROUGH REVIEW OF THE TAX RETURNS WHICH NONPROFITS ARE REQUIRED TO FILE. THE FEDERAL TAX RETURNS OF ALL NONPROFITS ORGANIZATIONS ARE AVAILABLE FOR PUBLIC INSPECTIONS AT THE OFFICES OF THE NONPROFIT ORGANIZATIONS.

14. **THE INTEGRITY AND ACCOUNTABILITY OF NONPROFIT ORGANIZATIONS IS GUARANTEED IN OTHER WAYS.**

IN ADDITION TO SCRUTINY BY THE IRS AND STATE REGULATIONS, MANY MAJOR NONPROFIT ORGANIZATIONS ARE ACCREDITED BY EITHER THE NATIONAL CHARITIES INFORMATION BUREAU OR THE PHILANTHROPIC SERVICE OF THE BETTER BUSINESS BUREAU, BOTH OF WHICH ARE HIGHLY RESPECTED ORGANIZATIONS. THESE TWO GROUPS PROVIDE RIGOROUS STANDARDS FOR NONPROFIT ORGANIZATIONS REGARDING DISCLOSURE OF FUND-RAISING COSTS, GOVERNANCE, AND ADMINISTRATION TO HELP ENSURE THAT THE PUBLIC TRUST IS PROTECTED.

15. **IMPLEMENTING OUR OPPONENTS' RECOMMENDATIONS WOULD NOT BE IN THE PUBLIC INTEREST.**

OUR OPPONENTS' BASIC POSITION IS THAT TAX EXEMPT ENTITIES SHOULD LOSE THEIR TAX-EXEMPT STATUS WHEN THEY PROVIDE PRODUCTS AND SERVICES WHICH ARE ALSO AVAILABLE FROM FOR-PROFIT BUSINESSES. THE EFFECT OF THIS RECOMMENDATION WOULD BE TO REQUIRE NONPROFITS EITHER TO WITHDRAW FROM PROVIDING MANY SERVICES OR TO PAY TAXES ON REVENUES DERIVED FORM PROVIDING SERVICES SUCH AS CERTAIN SCHOOLS, HOSPITALS, YOUTH AND ADULT RECREATION CENTERS, NURSING HOMES, AND SCIENTIFIC RESEARCH AND TESTING WHICH ARE ALSO PROVIDE BY FOR-PROFIT BUSINESSES. IN ADDITION, NONPROFITS WOULD NO LONGER BE ABLE TO RECEIVE TAX DEDUCTIBLE CONTRIBUTIONS WHICH BENEFIT MANY OF THESE ACTIVITIES.

IN CONCLUSION, THE FAIRNESS QUESTION RAISED BY SOME REPRESENTATIVES OF THE SMALL BUSINESS COMMUNITY ULTIMATELY IS THE QUESTION OF FAIRNESS TO INDIVIDUALS SERVED BY NONPROFIT ORGANIZATIONS. FROM THE FOREGOING, IT IS CLEAR THAT NONPROFITS SERVE THOSE INDIVIDUALS, THEIR COMMUNITIES, THEIR NATION, AND THE PUBLIC GOOD IN A VERY SPECIAL WAY THAT WARRANTS TAX EXEMPTIONS AND OTHER GOVERNMENT POLICIES WHICH ENCOURAGE THE FORMATION AND STRENGTHENING OF NONPROFIT INSTITUTIONS.

American
Association
of
Museums

STATEMENT OF

THOMAS A. LAINHOFF, DIRECTOR
GUNSTON HALL

on behalf of

THE AMERICAN ASSOCIATION OF MUSEUMS

U.S. House of Representatives
Committee on Small Business
Subcommittee on Procurement, Taxation and Tourism

June 16, 1994

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Good morning. My name is Tom Lainhoff. I am Director of Gunston Hall, the colonial plantation of George Mason, Father of the Bill of Rights. I am speaking today on behalf of the American Association of Museums, which represents the nation's 8,000 museums of art, history, science, and natural history, as well as zoos, botanical gardens, children's museums, specialty museums, and many others, including 1,100 corporate members, most of which are small businesses. I would like to ask that my written statement be placed in the record.

The mission of Gunston Hall Plantation, located in Fairfax County, Virginia, is to preserve, interpret, and promote this 18th-century historic site in order to educate the public about the international significance of its owner, George Mason, for "his unique contribution to the universal cause of human rights." We are open to the public seven days a week, 362 days a year. Educational opportunities that we offer include tours, a library and archives, lectures, exhibits, and special events. Our educational outreach includes school programs, publications, and on-line library services. These programs and services in no way compete with small businesses.

When George Mason wrote in the Virginia Declaration of Rights in May of 1776 "That all men are by nature equally free and independent and have certain inherent rights ... namely, the enjoyment of life and liberty, **with the means of acquiring and possessing property**, and pursuing and obtaining happiness and safety,." he was placing the right to earn a living on a par with the other "unalienable rights" that his close friend, Thomas Jefferson, would enumerate six weeks later in the Declaration of Independence. Just as the Virginia Declaration of Rights is seen by scholars as establishing the intellectual framework for the U.S. Bill of Rights, adopted some twenty years later, so too might this phrase - "with the means of acquiring and possessing property" - be seen as the basis for a Bill of Rights for Small Businesses.

Gunston Hall Plantation exists as a public/private partnership. Although we are an agency of the Commonwealth of Virginia, only about 50% of our annual operating budget of roughly $1 million comes from tax revenue. The remainder of our funding is derived from earned income, gifts, grants, and investment. State funding covers only our basic operational expenses; it is the supplemental income that enables us to accomplish our mission to help educate the public about this important Virginian and the significant contribution he made. That supplemental income helps us to ensure that Gunston Hall and all of its resources are available to everyone who wants to use them by subsidizing admissions fees and activities. There have been times in the past when this additional income literally has enabled us to keep our doors open. And, if the trends experienced by museums in the last two decades are any indication, these non-governmental sources will become increasingly important in years to come.

The keys to our success in acquiring non-state funding in support of our operation are two 501 (c)(3) non-profit corporations that were established by our governing board to aid in the development of the site as a museum of national significance. These two non-profits, the Gunston Hall Regents Fund and the Gunston Hall Foundation, operate our museum shop, our membership organization, and our endowment, among other things.

Our relationship with the small business community is one based on cooperation, not on competition. We are bound by the procurement policies of the Commonwealth of Virginia, even when expending non-state funds, and those policies encourage us to use small businesses whenever possible. Of the nearly 300 vendors with whom we conduct business on a regular basis, the majority are small businesses.

Some of our vendors, in fact, are in business specifically to supply the museum community in this country. Specialists in exhibit design and fabrication, conservation of collections, architectural investigation, and building restoration, to name but a few, are among those who do work for us on a fairly regular basis, and all are small businesses. Multiply our situation by the more than 8,000 nonprofit museums across the United States and you begin to get some indication of the cumulative impact of this market. Another measure of the number of specialized businesses is the "Product and Services Suppliers" section of the Official Museum Directory, which contains more than 1,800 listings.

In order to accomplish our mission in the way that only Gunston Hall, as an historic site, can do, we must attract visitors. Our interest in stimulating travel and tourism, therefore, is easily understood. One of the goals in our current long-range plan is to increase visitation at a rate of 10% per year for the next five years. In fact, visitation is currently expanding in excess of that rate, and our success has had - and will continue to have - a ripple effect on other businesses throughout the region. The business that our visitors bring to hotels, motels, restaurants, and others as they travel to Gunston Hall multiplies our impact far beyond the actual dollar amount of our gate admissions and shop sales.

When we stage programs and special events for our growing public audience, small businesses supply the printed materials, banners, catered meals and the like, and they participate directly in our large-scale events as vendors, supplying our visitors with food, beverages and other amenities.

The economic impact of the nonprofit arts, including museums of all types, has recently been documented by the National Assembly of Local Arts Agencies. Their striking study, entitled "Jobs, the Arts and the Economy," which we will distribute to the Subcommittee, demonstrates that nonprofit arts organizations alone generate $36.8 billion for the national economy. They support 1.3 million jobs and generate $3.4 billion annually in federal income tax revenue as well as $1.2 billion and $790 billion in state and local government revenue, respectively.. For example, in Pittsburgh, nonprofit arts organizations expended a total of $270,647,923, resulting in 9,386 full-time equivalent jobs. In Reno, the arts spent $27,602,761, resulting in 842 jobs and generating $732,667 in local government revenue. In Ann Arbor, nonprofit arts organizations spent $20,933,158, for a total of 437 jobs, generating $460,000 in local government revenue. Cultural organizations not only have a direct impact on the economy, but also on the entire business fabric. Arts districts attract business investment, reverse urban decay, revitalize struggling neighborhoods, and draw tourists.

Back at Gunston Hall, our museum shop, by design, is intended not to compete with for-profit gift shops but rather to serve as an extension of our educational mission. It exists not as a destination for customers but as a service to our visitors. Proceeds derived from shop sales are invested directly back into the

operation of the museum, either in support of our publications program or as direct project support. Our Museum Shop Manager works closely with the members of our curatorial staff to help ensure that new merchandise is directly related to the mission of our institution.

Most of the merchandise being offered for sale in our Museum Shop, with few exceptions, is produced and supplied by small businesses. This has become increasingly true in recent years. We have been moving toward smaller and more specialized vendors as efforts have intensified to ensure the museum relatedness of our merchandise.

No members of the small business community in Fairfax County have ever complained about unfair competition from our gift shop, which will gross about $120,000 in the current fiscal year.

At Gunston Hall Plantation, it is our conviction that in addition to our educational mission, we are contributing to the quality of life in our region and that we help to make our community not only a better place to visit but also a better place in which to live -- a better place for small businesses, their employees, and their customers.

Thank you very much for the opportunity to testify.

Testimony of

John McCarthy, IRSA: The Association of Quality Clubs

U.S. House of Representatives

Small Business Committee

Subcommittee on Taxation, Procurement, and Tourism

Hearings on Government and Non-profit Competition

June 16, 1994

Thank you, Mr. Chairman. My name is John McCarthy. I am the Executive Director of IRSA, the Association of Quality Clubs. I welcome the opportunity to appear before you today to discuss the damage which is being done to private tax-paying health and fitness centers across the country by unfair competition from both non-profit organizations and local and state governments. I commend you and your Sub-Committee for the leadership and courage you have demonstrated in examining this issue -- one that is timely in terms of our nation's preoccupation with both health care reform and deficit reduction.

First, Mr. Chairman, I would like to share with you some information about IRSA. IRSA is a not-for-profit trade association made up of owners, suppliers, and developers in the health, racquet, and fitness industry. We represent more than 2,000 clubs serving over 3 million consumers and over 300 manufacturers. Formed in 1981, IRSA helped set the pace for the expansion and evolution of the health and fitness club industry during the 1980s. IRSA has grown ten-fold during that time from a homogeneous group of tennis and racquetball clubs to a wide variety of clubs serving the multifarious needs of America's health conscious consumers.

IRSA is pledged to maintaining high standards for the fitness club industry, thus providing consumers an assurance that they are receiving the full benefit of their investment in the active, healthy lifestyle that club membership provides. IRSA has adopted model consumer protection legislation and works for passage by state legislatures. To that end, all member clubs must sign IRSA's Membership Pledge, adhere to its Code of Conduct, and meet the Association's eligibility standards.

Health and fitness has become big business in the USA, Mr. Chairman, and this fact should be, in my view, the starting point for our discussions about unfair competition. The reason why non-profit organizations are building so many facilities aimed at the upscale adult fitness market is very simply put -- profits. The motivation is not to fulfill the non-profit's original charitable purpose, the motivation is money.

Allow me to provide some general statistics on the fitness market for the Committee's background information. The total annual volume of our industry is $7.3 billion. We estimate there are presently 41,000 fitness facilities in the country serving sixteen and a half million members. Among them are 12,000 private health and sports clubs and 15,000 run by non-profit organizations or governments (the remainder are in hotels, apartments, country clubs, etc.). So you can see that non-profits and government facilities are already very serious players in this market. In fact, you could even say they play a predominant role.

Take the YMCA, for example. The Y is the nation's single largest provider of fitness facilities. In a typical year over 75% of the Ys' $1 billion-plus income comes from fees from members and about 20% from grants and contributions. As the *Chronicle of Philanthropy*, a journal which deals with all aspects of the non-profit world, recently reported, the YMCA is "big charity". If it were a business, it would rank somewhere in the middle of the Fortune 500.

UNFAIR COMPETITION FROM NON-PROFIT ORGANIZATIONS

IRSA believes that when "big charities" like the Ys aggressively develop and market fitness services to affluent Americans, they should not be considered charitable. We have argued this view

before the courts, Congress, and the Executive branches of our government. The question before us today is whether these "big charities" compete against small business in a fair way. The answer to that question is a resounding "NO".

Let me list a few of the unfair advantages a non-profit adult fitness center enjoys -- whether it be a local Y or JCC, a non-profit hospital, or a university. The non-profit health facility:

- is exempt from federal income taxes;
- is exempt from state income taxes;
- is exempt from local income taxes;
- is often exempt from sales taxes;
- is exempt from property taxes;
- receives almost a 50% discount on postal rates;
- receives special treatment from the federal government on unemployment insurance, minimum wages, and securities regulation;
- receives special treatment from the federal government on bankruptcy, antitrust regulations, and copyrights laws;
- enjoys exemption from a host of onerous state and local laws and regulations regarding franchises, inspections and bonds;
- escapes scrutiny by the Federal Trade Commission, a consumer watchdog agency empowered to prevent "persons, partnerships and corporations" from employing unfair methods of competition or engaging in unfair or deceptive acts or practices;
- is allowed to treat employees differently under federal tax law. Just one example: private-sector employees may contribute as much as $7,500 per year tax-free to a retirement account; non-profit employees can contribute up to $9,500;
- is allowed by tax laws to lower wage costs by offering generous benefit allowances.

The financial implications of these advantages are enormous. Mr. Roger S. Ralph, President of the Bel Air Athletic Club, Inc., Bel Air, Maryland, and the Harford County Coalition for Fair Competition have prepared a table demonstrating the competitive financial advantages enjoyed by the non-profit sector. I have included this table as an appendix to my testimony. They estimate that for a $3 million-a-year facility, located on a five acres of land, a tax-paying club would pay an additional $537,000 in costs compared to a non-profit club.

Why should tax-paying clubs have to operate with a handicap equal to 16% of their gross income? Why should non-profit organizations be allowed to plough these funds into further improvements of their clubs, a step which only increases their competitive advantage? Why are the local and state jurisdictions, and the federal government, denied the taxes generated by these basically profitable enterprises?

The uneven playing field facing the tax-paying club is apparent not only in the numbers but in the realities of people's business lives. For example,

- The Merritt Athletic Clubs operates health clubs in downtown Baltimore, Annapolis, and Salisbury, Maryland. Despite protests from the business community, a new $2 million YMCA was built in Salisbury, Maryland. The existing Merritt Athletic Club in Salisbury lost 33% of its members to the YMCA.

- In Sacco, Maine, New England Health and Racquet Club saw its sales fall 50% when the $2.6 million Northern York County Family Y opened less than two miles away.

Several years ago, the *Chronicle of Philanthropy* provided extensive coverage of the YMCA's aggressive search for profits in the adult fitness market. I would like permission to include this article in the record. The *Chronicle* described what happened to one club when the Y moved into his community:

> Until 1986, Kevin O'Connell was a big supporter of the Y.M.C.A.
>
> Then the Y opened a swanky, $10 million facility in Oakland, Cal., right around the corner from a health spa that Mr. O'Connell's family had owned and operated since 1936.
>
> Now a "For Lease" sign hangs on the building where Mr. O'Connell's health spa used to be, and Mr. O'Connell is planning to see the New Oakland Y.M.C.A. in court. He says the Oakland Y has used its tax-exempt privileges to compete unfairly with his business.
>
> These days, Mr. O'Connell has a new name for the organization that attempts to build body, mind, and spirit: the Yuppie Men's Cash Association.
>
> * * *
>
> When the Oakland Y lured away Mr. O'Connell's largest account, Blue Cross of California, revenues of his Executive Athletic Club dropped by a third. Last winter, two days before Christmas, he closed the doors of his spa for the last time.
>
> "We were in the neighborhood, on the same block, 50 years," mourns Mr. O'Connell, who now works at a branch of Gold's Gym, a national franchise of weight-lifting facilities. "Some of our members were with us 35, 40 years. Their grandchildren came to us."

Chronicle of Philanthropy, May 30, 1989.

New Unfair Threats From Non-Profit Hospitals

Non-profit hospitals must be added to the list of tax-exempt facilities which are competing unfairly against tax-paying clubs. More and more of our club members are complaining about this

phenomenon. Hospitals are opening fitness centers and attempting to carry their tax-exempt status over into these facilities. This is a serious new threat in our industry. Hospitals are well-financed institutions, and the pressure of health care reform causes them to seek new opportunities for fee income. While IRSA believes that regular exercise will greatly improve the health and productivity of the citizens of our country, we do not believe that any institution which opens a health club deserves a tax deduction. Otherwise, our clubs would ask for one as well.

In March of this year, the Supreme Court of South Dakota agreed with us. It ruled that "when the Legislature provided a tax exemption for human health care and human health care-related purposes, it did not intend to give a tax exemption for 'Splashbash Parties' and other similar activities." The court looked to see if the hospital fitness center was being used for charitable purposes and therefore was tax-exempt. It found that, despite the hospital fitness center's supposed policy that no person would be denied membership based upon an inability to pay, only 14 memberships out of 2,669 were reduced or free.

UNFAIR COMPETITION FROM PARKS & RECREATION DEPARTMENTS

The Parks & Recreation Departments and local governments across the country are also competing unfairly against private health clubs. Unlike the tax-paying private clubs, these are tax-spending health facilities. Club owners in Colorado, Oregon, Illinois, Arizona, and other states have discovered that it is easy to underestimate the strength and the threat posed by these lavish facilities.

These "Parks & Rec" departments are no longer satisfied with limiting themselves to baseball fields and playgrounds. Instead, they are building multi-million dollar facilities, with square footage many times the size of existing local health and fitness centers. These clubs are jam-packed with top-of-the-line, state-of-the-art training equipment. They offer aerobic classes, racquet courts, water parks with indoor beaches, basketball courts, saunas, steam rooms, and whirlpools.

The damage of unfair competition from Parks & Recs to small businesses in the fitness field will continue. In the last decade there has been tremendous growth in Parks & Recreation facilities. One magazine article has estimated that, between 1978 and 1988, there was a 114% increase in Parks & Rec budgets throughout the United States. In July 1990, *Athletic Business* completed a survey that suggested the growth would continue through the 1990s. Over 67% of the Parks & Recs they surveyed indicated planned growth or expansion in the next three years.

Here are some examples of tax-spending clubs that IRSA members are competing against today:

- A recreation center in Louisville, Colorado. The center was built at a cost of $3.5 million. It is a 57,000 square-foot facility with a 25-meter swimming pool, a 160-foot water slide in a second and separate pool, an elevated running track, free weights, circuit weights, racquetball courts, cardiovascular equipment, a gymnasium, and a lounge, hot tub, sauna, and solarium. The center offers aerobic classes and child care services.

- A 56,000 square foot city facility in Tucson, Arizona. It has a heated swimming pool, indoor track, collegiate-sized gymnasium, indoor racquetball courts, and a weight room. It was built at a cost of $4.5 million.

- A 78,000 square-foot center called Courts Plus in Elmhurst, Illinois. The center was renovated for $4.5 million. It contains an indoor pool, jogging track, aerobics facilities, dry sauna, whirlpool, steam rooms, free weights, cardiovascular equipment, tennis, racquetball, hand-ball and volleyball courts, and physical therapy services.

All of these facilities are tax-exempt. All cost millions of dollars. All rely on taxpayer financing. All of them charge an annual membership fee that is lower than the fees at a typical tax-paying club because the local taxpayer is subsidizing their costs.

The effect of these public competitors on private clubs can be swift and devastating. The city facility in Tucson forced one club owner, Jim Halkemeyer, to place his club in bankruptcy. Tom Dwyer, with a club located within a thousand yards of the Tucson club, saw his membership drop 30% in the first year after the city facility was opened. Another multi-million dollar Parks & Rec club in Lafayette, Colorado, forced four clubs -- all the for-profit clubs in town -- out of business within a year of its opening.

There are several reasons why the impact of unfair competition from Parks & Recs on private clubs is so swift and devastating.

The first is that, unlike unfair competition from a YMCA, the problems posed by Parks & Recs are trickier. A YMCA is subject to laws and regulations even though it is non-profit. If we can show that a non-profit organization does not comply with tax laws, then at least we have a place to start. We have a basis for a legal challenge.

With Parks & Rec districts, on the other hand, we don't have that luxury. Parks & Recs are divisions of government. And governments have very broad powers to do what they decide they want to do. The fight against Parks & Recs is primarily a political struggle, not a legal one.

In fact, competition from Parks & Recs is even more unfair and insidious than from non-profits because, in addition to enjoying all the benefits of tax exemption, the tax-spending clubs are run by governments who can write the rules the way they want to.

Also, Parks & Recs are not run like a business. The people in charge of the Parks & Recreation departments are either civil servants, elected officials, or political appointees. Their "businesses" are subsidized by the taxpayers and are not accountable to the market. Public officials who run a facility measure their success not by how efficiently they operate but by how big, how opulent, and how visible they can make their empire. The most serious danger of the aggressive entry of governments into the health and fitness market is that it destroys the market itself by removing it from entrepreneurs and destroying its competitive nature.

It is sometimes argued that local government should be allowed to build adult recreational facilities because these facilities offer low or affordable prices which make them available to the entire community. While Parks & Recreation District user fees may be low, these user fees represent only a portion of the cost to the taxpayer. In Oak Brook Parks & Recreation District, Illinois, a bond to finance a proposed Parks & Rec facility would have cost an average taxpayer at least $300 in taxes a year. The cost would be borne by all taxpayers, not just the facilities users.

The one encouraging sign in our fight against unfair competition from tax-spending clubs is the success we have had when we have taken the issue to the public. When the true costs of publicly-subsidized, luxurious health facilities are revealed, the voting public inevitably rejects them. The people of our country know what is a proper role for government and what isn't. Last November, the voters of Aurora, Colorado, soundly defeated (by a 2-to-1 margin) a $40 million bond proposal for recreational facilities for the Aurora Parks & Recreation Department. The proposed new fitness centers would have competed directly with at least nine privately-owned health and athletic clubs.

Good public common sense was shown again only a month ago in Livermore, California. The Lawrence Livermore National Laboratory, a federal government research facility, canceled its plans to build a fitness facility for its 8,000 employees after a public outcry and after the media had scrutinized the true cost to the taxpayer of the proposed fitness center. The taxpayers understand the difference between a tax-paying and a tax-spending health club. They know that a dollar spent on one of these facilities is one not spent on police protection, education, drug abuse programs, homelessness, or other critical social needs.

RECOMMENDATIONS

As I mentioned earlier, Mr. Chairman, we are encouraged by the Sub-Committee's interest in this problem which goes against the very grain of the American notion of fair play. We will work with you in forging proposals and framing ideas that will ensure fairness and competition to the health and fitness marketplace. Some of the steps which we would like to see this Sub-Committee and the Congress take immediately are:

(1) Once and for all determine the tax revenues which are being lost to the national Treasury -- and to local and state governments -- when non-profit organizations avoid payment of taxes for activities which are essentially commercial and competitive with private tax-paying businesses. To date, neither the Treasury Department nor any Committee of Congress has developed these numbers.

Over the past five years we have heard over and over again that "we don't want to balance the budget on the backs of the non-profits." That is not the point, Mr. Chairman. The point is having accurate estimates of the revenues which are being lost. To date, everyone has been so afraid of the non-profit lobbying Goliath that they have resisted even generating the numbers on lost taxes. We believe they are much more significant than many people think and could well run over $1 billion.

We strongly recommend that your Sub-Committee require the Treasury Department to provide public estimates of the revenues lost through avoidance of UBIT taxes, as well as potential new revenues to the Treasury if the UBIT law were strengthened to require all commercial operations of non-profit organizations to pay their fair share of taxes.

(2) Recently the GAO reviewed the extent to which "charitable" or non-profit hospitals were actually providing health care services to charitable and indigent cases. The results showed that the for-profit hospitals often served more indigent cases than the "charity" hospitals did. We urge that a similar GAO study be undertaken of the extent to which non-profit health and fitness centers actually serve needy individuals and charitable classes.

Only when we compare the results of (1) and (2) above, i.e., lost tax revenues versus poor persons served, can we truly determine what the costs to our society are, and the benefits derived from the privilege of tax-exemption which our society extends to the YMCAs, the JCCs, and other non-profit fitness club operators.

(3) Thirdly, we recommend to the Sub-Committee the same "bright line" test that we have advocated before the Oversight Sub-Committee of the House Ways and Means Committee. This bright line test will determine whether a specific health and fitness facility of a non-profit organization should pay UBIT taxes. Essentially, our test says that unless half or more of the members of a club in question are economically disadvantaged, the club should not be tax-exempt.

The specific language of IRSA's proposed bright line test is

> UBIT will apply to the income derived from the use of a facility for adult fitness, athletic, or recreational activities, if more than 50% of the persons who use the facility for such activities are individuals whose family income is more than the metropolitan area median income.

(4) With regard to competition from Parks & Recs, we recommend that the Congress adopt a Resolution stating that it is the sense of Congress that the public sector not provide goods and services to the American people which are available through the private sector, but perform only those services which are inherently governmental functions.

We further recommend that the Congress prohibit the use of any federally-funded personnel and/or equipment in facilities which offer services for a fee and which compete against private companies offering those same services.

Finally, Mr. Chairman, IRSA joins with its colleagues on the Business Coalition for Fair Competition in urging you to propose legislation which will mandate a definition of inherently governmental functions, prevent public sector organizations from providing goods and services in competition with the private sector, and delineate limitations for non-profit organizations as well. We also endorse our colleagues' call for a Federal Advisory Committee to help develop this legislation.

The members of IRSA thank you for the opportunity to present our views this morning, and for the interest you have shown in creating a more level playing field in the health and fitness industry.

APPENDIX to John McCarthy Testimony

The Non-Profit Or Government Sector Can Enjoy As Much As A $524,000 Annual Operating Cost Advantage Over The Private Sector On a $3 Million Athletic Club Project*

	Annual cost to public or non-profit sector	Annual cost to private sector
Annual Land Carrying Cost (assuming a land value of $100,000 per acre and a 15-year loan on $500,000 at 9% interest)	0	$60,856
Annual Building Mortgage (assuming a $2,000,000, 15-year loan at 9% interest)	0	$243,424
Furnishings and Equipment ($300,000 borrowed for 5 years at 11%)	0	$78,273
Postage (non-profit or public sector entitled to a 33% discount)	$13,320	$20,000
Real Estate Taxes (assuming a property value of $3,000,000 at a 50% taxation rate of $4 per $100)	0	$60,000
State income taxes (state tax rate of 7% on profit of $200,000)	0	$14,000
Federal income taxes (federal rate of 22.25% on first $100,000 and 39% on next $100,000)	0	$61,250
TOTAL ANNUAL COSTS	$13,320	$537,803
ANNUAL COST ADVANTAGE TO THE PUBLIC OR NON-PROFIT SECTOR:		$524,483*

*Prepared by Roger Ralph, President, Bel Air Athletic Club and Chairman, Harford County Coalition for Fair Competition, Harford County, Maryland. Assumes a $3,000,000 facility on 5 acres. In this example, the private sector would have to pass more than $537,000 in annual costs on to the customer simply to cover property taxes, income taxes, and club service. For a health club with 1,800 members, each would thus pay $538, or $29.88 extra each month. Since the YMCA or other non-profits or government agencies don't bear these costs, there is almost always pricing below market.

NASULGC National Association of State Universities and Land-Grant Colleges

House Small Business Subcommittee on Procurement,
Taxation and Tourism
10 a.m. on June 16, 1994
2359 Rayburn House Office Building

Testimony of Jerold Roschwalb
Director of Federal Relations
National Association of State Universities
and Land-Grant Colleges

Mr. Chairman and members of the subcommittee, I am pleased to have this opportunity to speak to you about the positive ways in which the universities and the small business community interact. I hope to lay to rest any concerns you may have that colleges and universities are unfairly competing with small business.

By way of background, the National Association of State Universities and Land-Grant Colleges has roots dating back to 1887 and includes176 institutions of higher education with campuses in every state. In 1992, NASULGC schools enrolled more than 2.7 million students. In 1993, the average cost of undergraduate in-state tuition and fees at NASULGC institutions was $2,685 per year. NASULGC universities have educated about half the members of the U.S. Congress in recent years and more than half of the current CEO's of America's Fortune 500 corporations.

Many of our institutions were founded as part of the First Morrill Act of 1862 which was passed by Congress and signed into law by President Abraham Lincoln. The Morrill Act provided federal lands to the states to be sold to support colleges of agriculture, military tactics, and the mechanical arts.

The Hatch Act of 1887 authorized each state to establish an agricultural experiment station in connection with the land-grant college. To disseminate information from the experiment stations' research, the Smith-Lever Act of 1914 created a Cooperative Extension Service associated with each U.S. land-grant institution.

In 1890, the Second Morrill Act was passed which provided further endowment for these colleges, with part of the funding to be used for institutions for black students. This led to the creation of 17 historically black land-grant colleges.

Justin Morrill must have been fairly radical for his time because he believed that everyone, including agricultural and industrial workers, should have the opportunity to obtain an advanced practical education.

If you will look in the back of the **NASULGC '94** booklet, you will find a listing of the NASULGC institutions in your State.

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Teaching and research are the primary mission of the NASULGC schools. We are particularly proud that 35 of the top 50 universities in total science and engineering research and development support are NASULGC institutions, according to a 1991 National Science Foundation report.

However, we just don't conduct research which sits on a shelf. We are about innovation and opportunity. Since this hearing focuses on competition, I wanted to bring to your attention a new NASULGC booklet, "The Competitve Edge: Universities and Industry Working Together," which will provide you with some examples of successful collaboration between small and medium-sized manufacturers and NASULGC universities around the country. A survey of 85 NASULGC institutions with industrial extension programs -- which typically run on a shoe-string -- found that they provided substantial assistance to business and industry more than 16,000 times last year and that they served more than a quarter of a million business and other organizations. For the small and medium-sized businesses which reached out for their technical assistance, these were the benefits:

- reductions in manufacturing/processing costs
- creation of new business or products
- creation of new jobs
- increased value/sales
- new markets

And we are working even today, with your colleagues on other Small Business

subcommittees to provide support for exciting and productive programs in the realm of competitiveness. The NSF office that administers the Small Business Innovation Research (SBIR) program reports that more than half of the projects awarded to small business involve university faculty, primarily engineers and scientists, bringing together business savvy and marketing skills with the unique knowledge of university science and technology faculty. I would add that more than a few of the faculty have left the campus to run their own small businesses.

Two years ago, University of Maryland president Don Langenberg testified before this Committee on the enormous value of the cooperative ventures in SBIR. Last year, NASULGC President Magrath testified on the wisdom of supporting the even newer STTR program. And in January, at the invitation of Milt Stewart, considered to be the godfather of SBIR and STTR, Dr. Magrath went to Salt Lake City to address a large audience drawn from the Mountain States as part of a symposium to encourage increased cooperation and ventures by small business and the academy.

Leaving aside the outreach programs that are our hallmark, NASULGC colleges and universities are generators of economic activity. For example, students in the State of Nevada spent more than $200 million last year above and beyond tuition and fees. This included $14 million for books; $38.6 million in transportation; $55 .3 million for housing, $45.7 million for food, $52.6 million for miscellaneous purchases such as clothes, drug store purchases and the like. I would hazard a guess that most of that was spent in the small business community. Interestingly, I have never seen a "Going Out of Business" sign on a small business on Main Street near a campus.

Having provided you with some background of who we are and what our mission is, I'd like to address some of your concerns. I participated in the UBIT debate 8 years ago. And I can tell you that while some small businesses may have had legitimate complaints then, times have changed.

While the small business community is facing new challenges, so are our colleges and universities. We are restructuring in order to operate more efficiently. This means that we are contracting out many of the services which we formerly provided to our students on campus. For example, food courts, at which a number of small restaurants operate, are proliferating. You may find a submarine sandwich shop next to The Country's Best Yogurt next to a pizza stand, with a Chinese restaurant and a New York-style deli across the way, all under one roof at the student union.

Today, if one of my campuses sponsors a trip, chances are excellent that the travel arrangements will be made through a for-profit travel agency.

Many of our campus bookstores are leased out to small businesses which run them and pay rent to the university but otherwise are like any small business. Others limit the goods which are sold to those needed by the students and unavailable elsewhere. On the whole, students are encouraged to patronize the small businesses near the campus.

Yes, we do some testing. A number of our schools were chartered to do agricultural testing more than 100 years ago. It's part of our mission to improve agricultural

production and to make the benefits of our research available to everyone at little or no charge.

Back in the early 1980's several computer manufacturers, as a business strategy, offered their computers to campus bookstores at cut-rate prices in order to get students to buy and become familiar with their machines. The goal was to foster brand loyalty. Today, the market has exploded with computer clones. It's an entirely different world. There are numerous computer and software stores, as well as mail-order houses, from which to choose. This adds up to a lot of options for customers and a lot of opportunities for small business.

On such short notice, I was unable to find someone to talk with about hospital laundries. However, a number of NASULGC institutions do have teaching hospitals which have a three-fold mission: to provide health care to patients, particularly to those who are uninsured; to conduct research into better and more effective treatments; and to educate the next generation of health care professionals including physicians, dentists, nurses and other allied health professionals. I do not know whether any of them have laundries, but I did find something else of interest in my research: When I picked up the June 14 issue of the *Chronicle of Philanthropy*, I learned that more and more non-profit health organizations are reconstituting themselves as for-profit organizations. The *Chronicle* reports that "at least two-thirds of all HMOs in the country are now owned by businesses, compared with fewer than 20 percent in 1981." The market is changing. I have attached the pertinent portions of the article for your review.

To sum up, colleges and universities are partners, not competitors, of small business.

We are working constructively and effectively to create more opportunities for small business and to enhance the productivity of small businesses all across America. We look forward to continuing our good relationship for many years to come.

STATEMENT

to the

COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON PROCUREMENT, TAXATION AND TOURISM
UNITED STATES HOUSE OF REPRESENTATIVES

HEARINGS ON GOVERNMENT WASTE AND TAX ABUSES BY GOVERNMENT AND NONPROFIT ENTITIES

by

HONORABLE JAMES D. SANTINI
CHAIRMAN
BUSINESS COALITION FOR FAIR COMPETITION

JUNE 16, 1994

Good Morning, Mr. Chairman and members of the Subcommittee. My name is James D. Santini and I am here today on behalf of the Business Coalition for Fair Competition (BCFC). First, Mr. Chairman, I would like to commend you for the leadership you have shown. By examining the issues surrounding unfair competition from government and nonprofit organizations, you are illustrating your commitment to small business.

The BCFC is an alliance representing thousands of U.S. businesses in many areas of the economy. Our membership includes many trade and professional associations and individual businesses. For more than a decade, the BCFC has articulated the concerns of small businesses regarding the problem of unfair competition from the government and nonprofit sectors engaged in commercial activities. We have attached a current BCFC membership list and brochure. [ATTACHMENT 1.]

As you may recall, last year I spoke to the Subcommittee, representing the National Tour Association, a member of BCFC. I spoke about the group tour industry's specific problems with unfair competition from both tax-exempt nonprofits and the federal government. Today I will provide a brief overview and examples of the expansive unfair competition problem the BCFC membership has experienced from both the governmental and nonprofit sectors. BCFC will also offer some very specific recommendations. While the combined problem of nonprofit and government competition reflect shared unfair advantages, the structural solutions differ somewhat. However, we believe both can be examined in the context of government waste.

During the course of these hearings, the Subcommittee will be hearing from a number of BCFC members on their industry-specific experiences (marked by an asterisk on ATTACHMENT 1). These will illustrate the scope of the unfair competition problem which we are just outlining today. In these hearings the Subcommittee will also hear about specialized fair competition problems associated with public monopolies, from the affected small businesses, and from their umbrella organization.

Fair competition among organizations can be achieved when competitors are not advantaged by tax exemptions or government funding. Many nonprofit and government entities are engaged in commercial activities in unfairly-advantaged, direct competition with taxpaying business. The major advantages vary but here is a list of just some of the privileges that government and nonprofit organizations enjoy when they engage in commercial activity--

- Directly funded by the public (in the case of government competition);
- Exempt from federal and state income tax;
- Exempt from property tax;
- Often exempt from collecting sales tax;
- Postal rate discounts;
- Special dispensation from the federal government on antitrust, copyright, wage, unemployment insurance, and similar laws and regulations with which non-subsidized commercial entities must comply;
- Eligible for government grants and similar funding mechanisms; and

- "Halo" advantage, a very real marketing and perception advantage in doing business with the public.

Finding remedies to these advantages through technical statutory amendments, with an eye on minimizing government waste, is a daunting task. However, a congressional mandate for reasonable fair business practices, a mandate from the top, would help alleviate the disadvantages suffered by small business in this country. This disadvantaged competition has a serious impact on our nation's economy by channeling business for services and products away from commercial companies, by reducing tax revenues for government and by misusing public support and trust.

On Government Competition--

The government increasingly offers goods and services that are available in the private sector. The government is responsible to the public for performing inherently government functions, such as national security, negotiating with foreign governments, governing and lawmaking, and protecting the health, safety and welfare of citizens. Based on the actual experience of the BCFC membership, here is a short list of industries that encounter competition from government: bus and group tour companies, engineering and professional scientific services, data processing, retailers, campground owners, sleep product manufacturers, and textile rental companies. It is a broad-based problem exacerbated by established functions within the government which compete with the very industries that generate tax revenues and resources for government.

The long-suffering argument "it can be done in-house for less" is unsubstantiated. No serious account of the government and economy's cost has been calculated to include the true cost of government overhead and growing bureaucracy, and the erosion of a stabilized private sector and tax revenue base.

Fundamental questions should be asked when a government entity is offering goods and services. Some examples include: Is the good or service a mandate of governing? If not, eliminate a provision that the public can get in the private sector. If it is a mandate, can the good or service be provided through the government from the private sector? If government engages in the commercial endeavor, how many businesses will lose business? How much annual revenue will be lost by a business? How much tax revenue will the government lose? How many jobs could be lost? Or if the service and goods are provided by private sector, how much tax revenue will be gained? Could jobs be created in small businesses? Will the government benefit by simply acting in an oversight capacity and reducing a bureaucratic organization?

We do occasionally see encouraging signs. For example the "Washington Business" section of the June 6, 1994 issue of the Washington Post (ATTACHMENT 6) contains an article on government spending in the DC area. The article states that "[t]he shift to buying goods and services that the government might once have provided for itself has helped fuel the growth of the private sector in the Washington metropolitan area..." Additionally, the Vice-President's "Reinventing Government" initiative could open the door to include a large-scale move in the privatization direction we would desire. And we

hope that will occur, rather than a conversion of existing federal facilities into competing entities.

For example, we read recently in Washington Technology (March 24, 1994) (ATTACHMENT 7) that Plasmatronics, a taxpaying entity out of Albuquerque found itself being solicited by a Department of Energy lab for a product (laser to treat severe burns) that was almost identical to one it had developed and patented. One point of the article seemed to be that the DOE labs were eager to utilize their capacity and capabilities "to find niches in a crowded commercial marketplace." Why provide a product or service that is already being adequately provided by the private sector?

Sometimes the government funds activities through grants. Where adequate restrictions are not placed on their use, we see examples such as the New York State company which designs and creates scenery, etc. for theatrical productions. They say they have seen non-profit competitors use federal funding from the National Endowment for the Arts to underbid them, including for out-of-state jobs. This should be considered wrongful use of direct federal funding as well as improper use of the tax subsidy enjoyed by the tax-exempt competitor.

To address these issues, we are asking for an appropriate congressional resolution and the establishment of a federal advisory committee. These recommendations are found in more detail at the end of this statement.

Regarding nonprofits in competition--

BCFC believes that the charge of nonprofit organizations is a honorable endeavor. As President Clinton and former President Bush both have illustrated by showing tremendous support for the nonprofit organizations' mission of public service, nonprofits complement the government role of benefiting the public's good and contributing to the social fabric of our country. As stories of abuse have unfolded in recent years, it is all the more disturbing to see that institutions long respected and relied upon are abusing their position and status for gains that dilute their purpose and misuse the public's support and trust. Also disheartening is the increasing number of organizations that easily attain the status of nonprofit from the government but are not held accountable for upholding their charter and the rules that regulate their industry.

Therefore, the Business Coalition for Fair Competition submits that Congress should engage in a thorough examination of the nonprofit organizations' benefits for and burdens on our national economic activity. In a sense, BCFC is calling for Congress to consider "Reinventing Nonprofits."

The IRS has recently estimated that over 1 million tax-exempt nonprofit organizations now exist, and more than 40% are "501(c)(3)" category public charities. The revenue producing level of all these entities is now approaching $500 billion annually.[1] (These numbers do not include churches).

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[1] Hearings Before the Subcommittee on Oversight, Committee on Ways and Means, on Federal Laws Applicable to the Activities of Tax-Exempt Organizations, 103rd Cong., 1st Sess., 1993 (testimony of IRS on 6/15/93 and exhibits). Appended as ATTACHMENT 2.

The most recent GAO report (2/87) on tax-exempt organizations competing with taxpaying small businesses included (pp. 20-21) the following findings: The tax-exempt community--

> 1. is diverse and has significantly increased in terms of number of organizations, statutory exempt categories, types of activities, and resources;
> 2. is dominated by section 501(c)(3) organizations, such as those engaged in charitable, religious, educational, and health activities with a small number of large organizations controlling a majority of revenue;
> 3. relies on various sources of revenue to finance activities; and
> 4. is increasingly reliant upon income-producing or commercial activities as a source of revenue.[2]

That GAO report noted that for 1982 the IRS showed about 870,000 exempt organizations. Clearly these entities as a whole are in a major growth mode.

With the conclusions above and the continued growth in this sector, a sustained look at this phenomenon and its fair competition components is essential. We have several recommendations to offer in this regard, an additional charge for the new federal advisory committee proposal presented above, and an update by the GAO on their 1987 report. As previously stated, our recommendations are included in more detail at the end of this statement.

Since "501(c)(3)" entities dominate the exempt organization sector, it is important to explore their activities. This designation is reserved for those entities exclusively organized and operated for "religious, charitable, scientific, testing for public safety, literary, educational," or one of a limited number of very limited other purposes.

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[2] Competition Between Taxable Businesses and Tax-Exempt Organizations (1987).

Based on our observations over the last decade, it is clear that only the level of creativity of those drafting mission statements to support the application of the tax-exempt hopefuls stands in the way of tax exemption for many types of activity. One area in which BCFC has increasingly become concerned is with what may be considered "educational" activities. By way of example, a specific nonprofit organization in Philadelphia that has come to the attention of BCFC has been operating tours on a tax-exempt basis. Upon scrutiny of their federal tax forms over the most recent 3 years, it is abundantly clear that they believe every revenue activity they engage in is exempt from tax. These activities range from one day visits to museums and places of cultural events to multiple day visits to spas and resort locations, such as the Greenbrier, Arizona (in the spring), the Hamptons, and Berkeley Springs, W. Va. This is an abuse of the intent of the Congress on what activities may be done on a tax-free basis. Moreover, it cannot be debated that a clear and unfair competitive advantage accrues to this cultural arts organization that runs these tours tax-free against those who pay taxes. It is estimated that 25-30 taxpaying companies that operate in the Philadelphia metropolitan area can provide these services.

Some cases are more subtle but just as harmful to taxpaying for-profit competitors. Consider the case of a hearing aid business. A tax-exempt health care clinic serves the general public by providing specialized diagnostic procedures to assist medical doctors in making diagnoses and providing various forms of auditory rehabilitation. When an individual attends that clinic, perhaps in response to an advertisement, <u>not to receive such services as a patient</u>, but rather to obtain a hearing aid or basic testing and fitting services,

then that person is a commercial customer, and any profits derived should be taxed, just as they would with a taxpaying competitor.

Certainly one way to deal with the growing problem of nonprofit organizations' growing abuses is for the Congress to more strictly limit those who can obtain and keep tax-exempt status, based on more exacting standards. Since the government has bestowed these advantages it must also carry the burden of assuring compliance and eliminating the advantages if abuse occurs.

This gets us into the test that, under current law, is supposed to level the playing field on federal taxation of commercial business activities. The "unrelated business income tax" (UBIT) is imposed on an otherwise tax-exempt organization if the activity is not substantially related to the exempt purpose. With such a subjective test ("relatedness") used for such subjective terms (e.g., "educational"), and with very little IRS enforcement, it is not surprising that not much tax revenue comes to the Treasury from otherwise tax-exempt organizations each year. The Congress should give careful consideration to the erosion of the tax base resulting from the trend that has seen the growth in nonprofits to have outpaced all other classes of entities in recent years.

The last substantial IRS study of the UBIT that we have seen is for 1987, and that was preliminary only. The data shows that gross unrelated business income was $2.8 billion, with taxes (reported on IRS Form 990-T, "Exempt Organization Business Income Tax Return"), and paid of $83 million.[3] A 1992 IRS Research Bulletin entitled "Form 990-T

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[3] The entire report entitled Exempt Organization Business Income Tax Returns 1987 is appended as ATTACHMENT 3.

Compliance"[4] shows under 60% compliance by public charities with the UBIT, based solely on actual filers of the 990-T. If our understanding of this data is correct, then the overall compliance rate must be even lower. It is important to the public, which has a "watchdog" role to play in the case of public charities that the IRS stay current on issuing research data on 990-T compliance. The public has no access to these tax returns as they are confidential documents under the law (IRC sec. 6103). The congress should press the IRS to keep the public notified of trends on the 990-T. Further it should be obvious that the research data begs for additional resources to enforce the UBIT laws. On a related, but different, matter--the annual exempt organization informational tax return, Form 990, which is subject to public inspection--the BCFC has sent a letter[5] to the Administration supporting their position and that of the Oversight Subcommittee of the Ways and Means Committee. That letter contains our support for several recommendations made regarding the Form 990 in the letter and report issued March 9, 1994 by the Oversight Subcommittee of the Committee on Ways and Means, on reforms to improve the tax rules governing public charities. The recommendations we are most interested in and fully support are those providing for improved public access to the Form 990, "Return of Organization Exempt from Income Tax," and increased penalties on exempt organizations which fail to timely, completely and accurately file their Form 990. We have included these below in our list of recommendations.

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[4] Copy included within ATTACHMENT 2.

[5] Copy appended as ATTACHMENT 4.

Overall, the BCFC believes that the subjective and virtually unenforceable nature of the device that is supposed to tax for-profit activities of otherwise tax-exempt organizations begs for change--expanded taxation of these organizations--particularly if the basic provisions on who may have a tax-exemption are not tightened.

Finally, in this regard, we are attaching [ATTACHMENT 5] a copy of the first pages of a most exceptional expose of the magnitude of the nonprofit issue including its fair competition component. The item is a reprint of the series entitled "Warehouses of Wealth: The Tax-Free Economy," which ran in The Philadelphia Inquirer from April 18 - 24, 1993. The first statement of findings, in the first article, is based on an analysis of 6,000 Forms 990 by the authors and states:

> Many nonprofits operate just like for-profit businesses. They make huge profits, pay handsome salaries, build office towers, invest billions of dollars in stocks and bonds, employ lobbyists and use political action committees to influence legislation. And increasingly they compete with taxpaying businesses.

Regularly we hear that it is inappropriate to tax the profitable sales of an (overall) nonprofit organization similar to a for-profit business because of the essential difference in their motives, uses of profits, and so forth. This is in error, because the ends do not justify all the means, and costs to competitors and the overall economy must be considered as well. The tax naturally diminishes the net available for public purposes. However, it does not eliminate, in any way, the ability of a nonprofit to continue funding charitable initiatives through sales of goods and services, on top of their donor base on other funding. Further, even if the Congress finds these arguments to be compelling, the tax can be at a

lower or phased-in rate through a transitional period, so that current public purposes are not diminished more rapidly than prudent policy would dictate. However, we find no good argument that the tax should be zero or subject to the current UBIT structure.

It is useful to also note that along with the annual economic advantage of beginning with no tax payments to make and maintaining that tax-free operating mode comes the market entry and start-up time advantages for new service and product ventures. Moreover, this can certainly result in pricing advantages to take away market share from taxpaying competitors. Further, on the expenditure side, the advantages can include, when compared with the taxpaying competitor, more marketing and promotional dollars, higher overhead dollars compared to revenue (thus translating into less need for efficient operations), and simply more time to get off the ground. This is particularly unfair to small business entrepreneurs who are exposed to so many possible hurdles to ultimate success in a free market system.

Often the nonprofit will have a donor base on which to test out a commercial business product or service, as well as their use of their "halo" effect, as a nonprofit organization, to influence the public to try their product or service. We believe the collective advantage of the factors just described is being used, more and more, to supplement and replace other, more traditional sources of revenues. It is particularly important, therefore that the financial aspects of such ventures be specifically described in the nonprofits annual tax forms (IRS Form 990), so that donors or buyers can better assess these activities. Further it is critical that those who begin these ventures find the general rule will be one of taxation,

rather than exemption, so that unfair pricing and market entry expenditure advantages will be diluted.

Unfortunately, we are seeing more and more effort being expended by those looking at starting a small business to attempt tax-exempt status as a way of avoiding that competitive disadvantage. The Congress should be concerned with this trend. Although a nonprofit organization, by definition, cannot distribute retained profits or funds to private shareholders or insiders, particularly at the small level, compensation techniques including deferred compensation and non-cash fringe benefits can effectively move annual profits to the insiders.

The BCFC has 4 specific recommendations to offer the Subcommittee regarding the unfair competition problem.

First, we would request that you consider introducing a sense of Congress resolution that it is the desire of the Congress to rely on the private sector to provide goods and services to the American people and that the government should limit its activities in all areas that are in competition with the private sector.

Second, the Congress should ask all the affected parties, government employees, charities and trade associations, and large and small business to take a hard look at the roles and responsibilities of government, nonprofits and commercial business in offering goods and service in commerce. BCFC recommends the establishment of a Federal Advisory Committee (FAC). The FAC would create a consensus-building environment to evaluate the service provided to society by these different factions and the responsibilities and objectives that must be met with any special government or government-endowed

status or public support. Congress should require a report from the FAC in 18 to 24 months, and use the findings to craft legislation that would delineate the roles of the government, nonprofit and commercial organizations, and establish a fair system of compliance.

Third, to complement the FAC activities and other Congressional examination of this issue, BCFC also requests at least two GAO studies

a) An update of the 1987 GAO study entitled, Competition Between Taxable Business and Tax-Exempt Organizations; and

b) To complement Vice President Gore's National Performance Review, we recommend a study of government entities offering goods and services that are available in the private sector.

Fourth, the BCFC urges the Congress to move forward on legislation to implement the recommendation contained in the above-described report of the W&M Oversight Subcommittee. Specifically, the BCFC is most interested in the provisions that would expand access to the IRS Form 990 and that would generally increase the penalty for failure to timely, completely and accurately file the Form 990. We believe these provisions would greatly enhance the taxpaying business sector's ability to serve as the public watchdog with regard to the for-profit business activities of tax-exempt organizations.

I thank you again for this opportunity to present our views on this ever-increasing threat to the small business community, unfair competition from nonprofits and government entities.

Testimony of

Alan D. Weinberger

Chairman and Chief Executive Officer
The ASCII Group, Inc.
Bethesda, Maryland

and

Chairman, Public Policy Committee
Computing Technology Industry Association

on

Unfair Competition Issues

before the

United States House of Representatives
Committee on Small Business
Subcommittee on Procurement, Taxation, and Tourism

Washington, DC
June 16, 1994

Mr. Chairman, Members of the Subcommittee:

It is an honor to appear before this Subcommittee to present testimony on certain unfair competition issues. I certainly appreciate the opportunity to examine the impact of unfair competition between non-profit organizations and for-profit companies engaged in the sale of microcomputer products. I congratulate the Chairman for convening these hearings.

My name is Alan D. Weinberger and I am Chairman and Chief Executive Officer of The ASCII Group, Inc. headquartered in Bethesda, Maryland. Founded in 1984, my company is one of the largest chains of independently owned resellers of microcomputer equipment, such as personal computers, peripherals and all forms of software. In total, The ASCII Group sells over $ 4 billion dollars worth of microcomputer equipment throughout the United States through its 700 dealers. As such, we are extremely conscious of the competitive landscape and pricing advantages for all of the thousands of products our resellers procure and sell. Operating in this fiercely competitive industry requires a keen sense of market and regulatory forces.

Mr. Chairman, I also have the privilege of serving as Chairman of the Public Policy Committee of the Computing Technology Industry Association (CTIA). CTIA is a national, not for profit trade association representing

over 3,000 companies from all segments of the microcomputer industry, including manufacturers, distributors, software publishers, resellers and related service companies. CTIA's mission is to foster high levels of professional competence and business ethics among its members and the entire industry and, through value-added services, standards work, and representation before federal and state governmental bodies, enhance the global competitiveness of its member companies. I am pleased to testify at this hearing on CTIA's behalf.

My company, like many other companies in the microcomputer industry, has experienced outstanding growth throughout the 1980s and into this decade. Our growth has mirrored the acceptance of the PC in both the business, school and home environments. An open market is essential to competing in this industry that literally reinvents itself about every 18 months with new products, technologies, upgrades and services.

CTIA believes that fair competition is more than just a theoretical or abstract concept found in economics texts. Fair competition is, or should be, the controlling parameter to which we should all subscribe. Laws and regulations, which protect or permit certain anti-competitive forces from impinging upon those who seek to compete in the open market, should be recognized for what they in truth do promote.

Mr. Chairman, CTIA believes that certain laws and regulations do not adequately protect against unfair competition. Specifically, CTIA is concerned that certain non-profit organizations, properly exempted from taxation by the Internal Revenue Service, are improperly permitted under their tax exempt charter to market and sell computers and computer related equipment.

In essence, a for-profit computer reseller and a non-profit computer reseller can be located next door to each other, have the exact same look and feel, market and sell the exact same products, provide the exact same service and warranty work on the exact same products, and advertise the exact same products next to each other in the exact same newspapers. The only difference is that for-profit computer resellers pay corporate taxes and the non-profit computer resellers do not. We do not believe that represents fair competition. Mr. Chairman, CTIA believes that if it looks like a duck, walks like a duck, and quacks like a duck, it is probably a duck. We believe that all ducks should be taxed the same.

In many, but not all, cases, the non-profit computer reseller is a college or university bookstore which may be owned or licensed by that college or university. While we are aware that several other non-profit entities engage or have engaged in the sale of computers and computer related equipment, including, for example, the

Archdiocese of a major American city, the focus of my testimony today is on college and university bookstores.

Nestled tightly within the idyllic campus quadrangles and poised against the backdrop of the seemingly halo-like title of "educational institution," college and university bookstores that market and sell computers and computer related equipment are, in every respect (save payment of taxes), the same as all other computer resellers. College and university bookstores attempt to justify their involvement in the computer reseller arena, arguing, correctly so, that a personal computer is a valuable tool for students that enhances the educational process by augmenting the opportunities of learning.

Absent from this equation, however, is the fact that the bookstores sell not just to students, but also to faculty, staff, relatives of students, and friends of students. Furthermore, businesses who employ students can purchase through this indirect channel. In reality, Mr. Chairman, almost anyone can purchase these products at special discounts from such bookstores.

To illustrate the impact of this unfair competition issue, I would like to offer several examples for the Subcommittee's consideration. In reviewing these examples of unfair competition, it is important for the Subcommittee to understand how vastly different the prices for the same computer can be between a for-profit reseller and a bookstore. As a result of special school

purchase agreements with manufacturers under an exemption from the Robinson-Patman Act for non-profit entities, and exemption from federal and state taxation as a for-profit business, college and university bookstores that market and sell computers and computer related equipment can, in many cases, offer goods for sale at retail which are much less than the wholesale cost of the same exact goods of the for-profit computer resellers. When considering the full cost of computer systems, the difference in price can be several hundred dollars. Multiply this by about 3,000 such bookstores and the costs in uncollected taxes runs into the many millions and the unfair sales into the hundreds of millions of dollars out of the pockets of for-profit resellers and their wholesalers.

Some examples to illustrate our position:

First: A computer reseller in Ann Arbor, Michigan, has been effectively closed out of the retail market because of the price pressures from the University of Michigan bookstore. Unable to compete with the bookstore, arguably the largest computer dealer in the area, this computer reseller currently engages in sales and service to businesses and no longer maintains a storefront. Another ASCII Group dealer, Showcase Software, Inc. in Freeland, Michigan, has lost numerous sales on this price differential to Michigan State, Morehouse State, and the University of Michigan.

Second: A computer reseller in Kansas estimated that their sales dropped by 91% when the University of Kansas

bookstore began to market and sell computers and computer related equipment. An ASCII Dealer, Grafico, Inc. in Baltimore, Maryland, is not able to compete with the University of Maryland bookstore for the same reason.

When contemplating these examples, it is important to note that every sale of a computer or computer related equipment reduces the income tax revenue stream from the for-profit businesses. If a for-profit computer reseller attempts to compete on price with a bookstore and reduces their prices, total tax revenue is reduced. When the bookstore lowers their prices to beat the for-profit reseller and to maintain their price differential advantage, tax revenue is reduced even further. This pricing cycle eventually ends when the for-profit reseller begins to run a negative cash flow or exits the market completely. With less competition in the market, the bookstore can then in effect control prices.

In addition to being shut out of markets completely, it is important to note how this unfair competition issue imposes some very real direct additional costs on computer resellers. Savvy customers seeking bargain prices for computers and computer related equipment will seek advice and counsel from extensively trained and skilled sales personnel at for-profit resellers, engage in an intellectual "touch and feel" to determine exactly what products to purchase, and then purchase the products from the bookstore at a substantially reduced cost.

How do we know this happens? Customers bring products purchased from the bookstore to for-profit resellers to perform service or warranty work. Thus, not only is it nearly impossible to compete on the sale of the goods, but for-profit resellers serve as unpaid sales consultants or, under contract from the manufacturer as an authorized dealer, as a service center for goods purchased across the street.

School books and computers are very different. Course books are used only for a term or two and have limited or no use thereafter. Indeed, a course book is usually created by a professor just for one course. A computer is more like an automobile in so far as its utility to a student outside a particular class and his or her life outside of school. It is the vehicle of travel along our burgeoning information superhighways. No one on this Subcommittee would suggest that college bookstores should sell automobiles at unfair prices which would hurt independently owned auto dealers. Why should such stores have the right with computers?

Mr. Chairman, CTIA believes that unfair competition between for-profit computer resellers and bookstores that market and sell computers and computer related equipment must be resolved. We are certainly willing to work with the Congress, this Subcommittee and any private groups to shape a constructive examination of the entire subject and to begin to shape the framework for resolving this unfair competition issue.

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Again, thank you for permitting me to appear before the Subcommittee this morning.

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